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CORPORATE GOVERNANCE IN THE BALTIC STATES

Firm level effects and key problems

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ABSTRACT
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Objectives The first objective of this study is to evaluate the effects of good corporate governance and ownership concentration to company valuation and performance. The second objective is to identify the most serious corporate governance problems in the Baltic markets today.

Data The sample includes 67 companies listed in the Estonian-, Latvian- and Lithuanian stock exchanges. In the study a corporate governance index is formed on the basis of assessments made by 13 local market participants. The financial data is collected from 2004 annual reports. Additional ownership information is collected from the local stock exchanges

Methods The study is based on a survey questionnaire sent to local market participants in September 2005. The hypothesis are then tested using an ordinary least squares regression and with a logistic regression, both with multiple variables.

Results A positive correlation is found with a high governance score and company valuation, but evidence of the effects of good governance to company performance is insignificant. Also no statistically significant effects of concentrated ownership to company valuations or performance are found, although very high ownership concentration does seem to affect valuations negatively. Additional tests on corporate governance and dividend policy show a positive correlation, but effects of good governance to the amount of dividends is inconclusive.

The key governance problems in the Baltic are poor transparency, management quality and minority protection issues. Concrete findings include the lack of laws requiring mandatory bid offers to minority shareholders in delistings in Estonia and Lithuania and the Lithuanian law on companies, which states that the declaration date for e.g. dividends is also the record date. On a country level, Latvia scores significantly lower governance scores than Estonia and Lithuania.

Key Words Agency Problem, Corporate Governance, Emerging Market, Ownership Concentration, Transparency, Investor Rights, Baltic States, Estonia, Latvia, Lithuania

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CORPORATE GOVERNANCE BALTIAN MAISSA

Yritystason vaikutukset ja pääongelmat

Tavoitteet Tutkielman tavoitteena on selvittää corporate governancen ja keskittyneen omistajuuden vaikutuksia yritysten markkina-arvoon ja tehokkuuteen. Lisäksi tavoitteena on tunnistaa Baltian maissa esiintyvät vakavimmat corporate governance -ongelmat.

Data Otos sisältää 67 Viron, Latvian ja Liettuan pörseissä listattua yritystä. Tutkielmassa luodaan corporate governance -indeksi 13 paikallisen markkinaosapuolen tekemien arvioiden perusteella. Yritysten tilinpäätöstiedot on kerätty vuoden 2004 tilinpäätöksistä. Lisätiedot yritysten omistusrakenteesta on kerätty paikallisista pörsseistä.

Menetelmät Tutkielman tulokset perustuvat kyselytutkimukseen, joka suoritettiin syyskuussa 2005 paikallisille markkinaosapuolille. Tutkimushypoteesit analysoitiin käyttämällä usean muuttujan logistista ja PNS-regressiota.

Tulokset Hyvä corporate governance arvosana ja yhtiön arvostustaso korreloivat positiivisesti, mutta tulokset eivät viittaa siihen, että hyvällä governancella olisi vaikutusta operatiiviseen tehokkuuteen. Myöskään keskittyneen omistuksen vaikutukset yrityksen arvostukseen tai operatiiviseen tehokkuuteen eivät olleet tilastollisesti merkittäviä. Kuitenkin erittäin keskittynyt omistus näyttäisi vaikuttavan negatiiviseti yrityksen arvostukseen. Lisäksi tuloksista ilmenee, että corporate governance ja yritysten osingonjako korreloivat positiivisesti, mutta hyvän corporate governancen vaikutukset osinkojen suuruuteen ovat merkityksettömiä.

Suurimmat governance ongelmat Baltiassa ovat yritysten heikko läpinäkyvyys, yritysjohdon osaamisen puute sekä vähemmistöomistajien asema. Esiin nousivat myös Viron ja Liettuan puutteliset lainsäädännöt: pääomistaja ei ole velvoitettu tekemään ostotarjousta pörssilistalta poistuneen yhtiön jäljelle jääneistä osakkeista. Lisäksi Liettuassa on osakeyhtiöitä koskeva laki, joka määrittelee esimerkiksi osinkojen täsmäytyspäiväksi tapahtuman ilmoituspäivän. Yleisesti Latvian yritysten governance tulokset ovat huomattavasti heikompia kuin Viron ja Liettuan tulokset.

Hakusanat Agentti-päämies -ongelma, Corporate governance, Läpinäkyvyys, Kehittyvät markkinat, Omistuksen keskittyminen, Sijoittajien oikeudet, Baltian maat, Viro, Latvia, Liettua

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1. Introduction

In recent years there have been multiple corporate scandals on both side of the Atlantic involving excessive management perks, creative accounting and even outright fraud. In many cases this has been a result of serious agency problems between the management and company shareholders. Jensen and Meckling (1976) define an agency relationship as a contract under which one or more persons [the principal(s)] engage another person (the agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent. The agency problem arises from the divergence of ultimate goals between the agent and the principal. Whether this divergence results in investments into "second best" projects, as an unscrupulous use of the company's resources for personal use or in the most extreme cases a physical robbery of the company's cash register, in all cases company resources belonging to the principal are used by the agent in a manner that is not in the best interest of the principal.

La Porta, Lopez-de-Silanes, Shleifer and Vishny (2000) (later referred to as "LLSV") define this "stealing" as expropriation, which can take many forms: stealing the profits by selling the output, the assets or additional securities of the firm to insiders at below market prices. Such transfer pricing, asset stripping also known as "tunneling" and investor dilution, though often legal, have largely the same effect as theft. In other instances, expropriation takes the form of diversion of corporate opportunities from the firm, installing possibly unqualified family members in managerial positions or overpaying executives.[1]

As Johnson, La Porta, Lopez-de-Silanes and Schleifer (2000) show, tunneling is not a problem only in emerging markets, but is also legally possible in developed countries. If this kind of activities happen in the Western, well developed markets

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[1] Irrationality of managers might also be a problem as Katy Daigle reported in her article Bill Improves Shareholder Rights in Russia, Moscow Times, July 14, 1998: "One company director…owned over 51 percent of a company,…yet took personal bribes of about $10,000 to push through decisions that robbed the company of millions. Obviously, this man doesn't understand what he's doing." Fox and Heller (1999)

with advanced corporate governance codes and well developed and enforced legislation, how bad is the situation in emerging markets with limited or no corporate governance codes, undeveloped legislation and sometimes nonexistent enforcement? Fox and Heller (1999) and Black, Kraakman and Tarassova (2000) describe some of the most infamous fiascos during and after the Russian privatization process, which provide horrific examples of large-scale misuse of position, poor legislation and enforcement. [2]

To protect the principal's interest and to create a working market based economy, where company ownership and management is separated to a large extent, numerous mechanisms have been created to tackle the agency problem and other issues involved. These are more commonly referred to as corporate governance. Corporate governance can be defined as a set of mechanisms that induce the self-interested controllers of a company (agents) to make decisions that maximize the value of the company to its owners (the principals) or as Shleifer and Vishny (1997) put it: "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment". It is thus a framework of both legal boundaries and company specific practices, which try to minimize agency costs.

The obvious advantage of good corporate governance is the lower cost of financing for companies raising capital from outside equity investors because of the lower risk premiums demanded by investors (see e.g. Chen, Chen and Wei 2003). In an emerging market the agency costs, defined by Jensen and Meckling (1976) as the monitoring expenditures by the principal, the bonding expenditures by the principal and the residual loss, can be substantial compared to developed markets. Due to less developed legislative framework and poor enforcement, the monitoring needs of the principal are higher than in developed markets where

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2 One notorious example involved Krasnoyarsk Aluminum, which deleted a 20 percent stake held by the British Trans World Group from its share register, the only legal proof of ownership, effectively wiping out the foreign ownership. Originally taken from Natasha Mileusnic, The Great Boardroom Revolution, Moscow Times, July 16, 1996; David Fairlamb, Moscow Madness, Institutional Investor, July 1995. Fox and Heller (1999)

some of these costs are borne by the society e.g. laws protecting minority shareholders or acts carried out by the local Financial Supervision Authorities.

Another advantage of good corporate governance is the increased stability of the financial market and the surrounding society. Examples include the mid 90's Ponzi scheme in Albania, where the large-scale collapse of the schemes dragged the country within weeks into anarchy, widespread violence, plundering and food shortages (Bezemer 1999). In Russia roughly 5 million investors lost their money in MMM Bank's[3] failure, instabilizing the local market. Poor corporate governance was also a very important element in the Korean crisis in 1997: the Korean chaebol (conglomerates) had created a complex web of cross-guarantees and cross-equity holdings that allowed weaker affiliates access to credit markets and reduced accountability for bad investment decisions. These cross-shareholdings allowed a dominant family to control a company, sometimes with little of its own capital at risk. In addition, assessment of the chaebols' health was made difficult by the absence of consolidated financial statements. (Chopra, Kang, Karasulu, Liang, Ma, Richards 2001)

In short, good governance, including both legal framework and company specific charters can help an emerging market to direct it's scarce resources to necessary investments and provide increased trust and stability to the companies and to the financial system in general. These are a basic requirement for sustainable economic growth.

1.1 Objective of the Study

There are numerous previous studies that focus on different aspects of corporate governance. However, many academics have concentrated their attention on the large developed markets such as US, UK, Germany and Japan bypassing some of the small developing markets. Paradoxically, these are the countries, in which

[3] The creation of Sergei Mavrodi, who avoided jail by becoming a Duma member in 1994. Beim and Calomiris (2001)

good corporate governance would be most beneficial to economic development. Most studies involving these small emerging countries concentrate on certain aspects of governance such as the legal framework, overall corporate governance developments or market structure characteristics, offering little evidence on the actual company level implementation of good corporate governance and its effects on company level performance. The few studies that exist focus on Asia's emerging economies, where the situation is somewhat different from the transitional economies of Eastern Europe. The former "Iron Curtain" countries regained independence only 15 years ago and started to develop their societies into market economies, while most of the countries in Asia and Latin America have already been market economies for decades.[4]

The lack of corporate governance research in the transitional economies is partly explained by the difficulties in collecting relevant data as the disclosure and transparency requirements and their enforcement vary between the countries: One cannot assess the effectiveness of the management board if a company does not even publicly disclose the names of the board members or the information that is available is seriously outdated. The new EU member countries have however developed somewhat further, but still governance assessments based on the companies own voluntary disclosure is practically impossible.

The purpose of this study is to give more insight into this less researched area of corporate governance by evaluating corporate governance practices in the three Baltic countries: Estonia, Latvia and Lithuania and to check if good corporate governance has an effect on company performance and valuation. It will thus provide needed evidence on the firm level effects of good corporate governance in a transitional environment.

The second objective of the study is to identify key problem areas with corporate governance in the Baltic markets. This includes legal and regulatory problems as

[4] Being a market economy does not mean that they necessarily follow a western democracy though.

well as problems resulting from wrongful business practices. In addition to generalized statements of poor governance conducts, my ambitious goal is to point out specific legal, regulatory and operational issues, which could be dealt with to improve corporate governance.

1.2 Data and Methodology

This study includes 67 listed companies from the main list and the second/current/I -list in the Estonian, Latvian and Lithuanian stock exchanges. For a complete list of the companies and short description of their activities see appendix 1. To evaluate the companies' corporate governance, I have sent a questionnaire to local market participants, asking them to evaluate local companies based on three criteria: Transparency and disclosure, management and board quality and investor rights. Based on these answers I have created an overall corporate governance index, which is used as a proxy for the level of corporate governance in any particular company. Individual governance aspect scores are also used to evaluate company valuation and performance respectively. Additional tests are done to identify the effects of concentrated ownership to firm performance and valuation. The performance and valuation of the companies is measured with Tobin's Q and ROA.

In addition, the local market participants express their views on specific governance issues. The answers are used to identify the key corporate governance problems investors still face in these countries.

1.3 Summary of Key Results

The evidence from the quantitative analysis shows that firms with better corporate governance are valued higher in the market. This is consistent with previous studies [see e.g. Klapper and Love (2004), Black (2001a, 2001b), Black, Jang, Kim (2005) and Durnev and Kim (2005)]. Also inline with the results from Diamond and Verrechia (1991) and Chen, Chen and Wei (2003) the transparency

and disclosure practices of a firm are a determinant in company valuations. However in this study better transparency seems to be a weaker determinant on a stand-alone basis than the overall governance score. Ownership concentration on the other hand, and contrary to previous studies [see e.g. Claessens and Djankov (1999a, 1999b), Claessens, Djankov and Pohl (1999) and Xu and Wang (1999)], is not statistically significant in predicting valuations. However, with very high majority ownership stakes, the ownership seems to affect valuations negatively, implying possible expropriation.

Contrary to Klapper and Love (2004), but inline with the results of Black, Jang and Kim (2005), I find no evidence that better corporate governance would positively affect company performance. The effects of higher ownership concentration to firm performance are also inconclusive. Regression results on dividend policy are no different: I find no statistically significant evidence that ownership concentration would have an effect on the company's dividend payouts, contrary to the theory of Jensen and Meckling (1976). With very high ownership concentrations the dividend payments are actually less likely than in companies with a more broader ownership structure. On the other hand, good corporate governance is found to affect dividend payouts positively inline with the works from Mitton (2004), but further tests on the effects of good governance to the amount of dividends paid provide only insignificant results. Also contrary to previous studies [see Furman and Stiglitz (1998) and Berglöf and Pajuste (2005)] tests to determine the effects of transparency and disclosure to the volatility of the stock provide only insignificant results. Regression results of the effects of ownership concentration to company transparency and disclosure policies are also insignificant.

The study succeeds in identifying several key problem areas in corporate governance. The findings include both legal and regulatory issues and issues related to poor corporate culture. Many survey participants see the lack of transparency and disclosure as the key problem area. Especially continuous disclosure, including events such as profit warning, seems to cause problems in

other areas such as insider dealings. As a somewhat related issue the survey participants also see poor management quality and concentrated ownership structure as hindering future improvements in governance. A common theme among the participants is the desire to see more enforcement action especially from the local stock exchanges and securities supervisors. The differences among the Baltic countries seem to be surprisingly large. Estonia is by far the most advanced while Latvia is seen to be trailing the others.

Legal findings include the Lithuanian commercial law, which causes an unorthodox procedure for e.g. dividend payments and capital changes, whereby the stock is ex of the event before the event is official. Other legal issues related to minority protection include the lack of mandatory buyout laws in delistings in Estonia and Lithuania. Also the Estonian legal system still has several loopholes or exceptions, which lower the effectiveness of mandatory bid regulation. Other problematic issues include the lack of possibilities for minorities, especially small investors, to seek protection through legal means, due to the long processing time and costs. In addition many courts have limited understanding of commercial issues: The survey participants especially point out the problems in determination of "fair" price in buyouts.

1.4 Limitations of the Study

The major limitation of the study is the small number of participants in the survey, which increases the risks for participant's bias. The perception of the participants is most likely based on historical data and might therefore be out-of-date or biased due to other historical events. Unfortunately, because the Baltic markets are so small, the number of experienced local players is also limited. Another problem evident in this study is the sample selection bias. Because my sample only uses the listed companies of the Baltic countries, it is inherently excluding a large part of the total statistical population. Thus it especially discriminates against small companies, which have no representatives in the stock exchange trading lists.

In addition, this study has several endogeneity and structural reverse causality problems. For example the direction of causality between performance and ownership concentration is unclear: concentrated ownership can improve firm performance through better monitoring, but well performing companies also attract investor as noted by Börsch-Supan and Köke (2002).

1.5 Structure of the Research Paper

This study is structured so that the relevant literature is presented in the second chapter. The three Baltic markets, their characteristics and legal frameworks are presented in the third chapter. The fourth chapter gives detailed explanations about the hypothesis, while the fifth chapter focuses on the methodology and data of this study. The sixth chapter presents both the quantitative and qualitative findings. The last one is the concluding chapter, which summarizes to most relevant issues discussed in this thesis.

2. Corporate Governance in Emerging Markets – Literature Review

In the recent years there has been a huge research interest in both theoretical and empirical corporate governance. Through the 1970's and 1980's the focus was primarily on governance in the US and while this research is still continuing, the focus has shifted to other markets as well. First came the other major world markets of Japan, UK and Germany and during the last couple of years also some of the smaller countries. However, the emerging markets, especially the transitional economies of the former Soviet Union have drawn surprisingly little interest from the academic world. Even Russia has sparked only a few corporate governance studies that go beyond a generalized framework to an empirical research level with concrete findings. The only widely known paper trying to do this is the study from Black (2001a, 2001b). Some of the most recent papers such as Berglöf and Pajuste (2005) provide firm level evidence on transparency and disclosure practices of Eastern European companies, but this is only one aspect of corporate governance.

Corporate governance studies can be roughly divided into two sub-sections: Studies that examine the internal and external control mechanisms. Usually the internal mechanisms consist of company specific attributes that contribute to corporate governance such as ownership structure, board structure, executive compensation and company charters. The external mechanisms include the legal and regulatory system, the market for corporate control (takeover market including proxy fights) and bank monitoring. Research in emerging markets, however, is usually more limited. Research focusing on specific company charters, company attributes such as board size or board independence and takeover markets is non-existent, partly because of the lack of data and partly because some corporate governance mechanisms are ineffective or do not work at all with the highly concentrated ownership structure evident in many of the countries. Bank monitoring, which is often mentioned, might be effective because of the lack of other financing possibilities for companies. However I would argue that the monitoring incentives of the financing bank and a minority shareholder

are not aligned. The bank is perfectly happy as long as the company can live up to its commitments and provide enough collateral for its debts (so as to minimize the possibility of default risk increasing), no matter how much the company insiders or dominant owner "steals". It is the residual owners, who will suffer from this activity.

In this chapter I will first present the most relevant studies applicable to emerging markets concerning the external mechanism and internal mechanisms of corporate governance. In addition some more general or mixed studies are presented.

2.1 External Mechanism – Legal and Regulatory System

Early studies of corporate governance in the developed market focused on board structure or ownership patterns dismissing the effects of the legal and regulatory framework. For example Jensen (1993), in his study of forces changing the worldwide competitive market, acknowledges the legal system as a corporate governance mechanism, but claims it to be too blunt of a weapon to deal with the agency problem.

This view is challenged by Schleifer and Vishny (1997) who suggest that the ownership structure and the development of the stock market may be determined by the quality of shareholder protection. LLSV (1997,1998) continue this idea by studying the legal rules governing shareholder and creditor protection, their legal origin and the quality of enforcement in 49 countries. They separate legal systems by their origin to English, French, German and Scandinavian systems. According to the study, the English common law, made by judges and incorporated into laws, provides the best investor protection, whereas the French civil law offers the least protection. The German and Scandinavian systems lie in the middle. They also find that the concentration of ownership in the largest public companies is negatively related to investor protection, consistent with their hypothesis that small, diversified shareholders are not important in countries where investor protection is weak.

In their later papers, LLSV (1999b, 2002) extend their previous research of investor protection with company level valuations. They use a sample of 539 companies (LLSV 2002) in 27 wealthy economies. Consistent with their previous research, they find evidence of higher firm values in countries with better protection of minority shareholders.

Even though all LLSV studies focus more or less on developed markets, they provide a basic theory, which can be applied to emerging markets. Berglöf and Claessens (2004) transform LLSV emphasis of investor protection to better fit emerging markets. Berglöf and Claessens point out that all corporate governance codes or set of rules, international and national, company specific or general are actually very similar. For example most Eastern European countries copied western company laws after gaining independence in the early 90's. These laws were later fine tuned, but in essence the laws as they are printed do not differ that much (especially after the modifications made for the EU). Yet, governance practices differ substantially among countries and companies. For most parts these differences can be explained by the quality of enforcement of laws and regulations.

Berglöf and Claessens views get further support from Pistor, Raiser and Gelfer (2000), who analyze the legal environment in transitional economies beyond the law books to actual enforcement and find that the effectiveness of legal institutions has a much stronger impact on external finance than the extensiveness of the law book. A prime example of this is Russia, where despite laws protecting minority shareholders, the reality is something totally different. For example still just a couple of years ago the fair price to stall a criminal investigation was $50.000 in Moscow (Wolosky 2000).

In addition to laws controlling corporate governance and investor rights, many countries and organizations have introduced corporate governance codes. The

most notable one is the OECD Principles of Corporate Governance (2004).[5] These codes can be considered as regulatory methods, secondary to actual laws, of corporate governance. The difference between laws and these regulations is their legal status. The codes can be issued as an order by a local authority (close to a law), they can based on a contractual basis, such as a prerequisite for public listing or they can be just guidelines, issued by the authorities, the local stock exchange or for example the chamber of commerce. In my mind the possible problem with the codes is the enforcement, which can be problematic especially if the codes are issued only as a guideline without sanctions to companies that choose to disregard them.

2.2 Internal and External mechanism – Transparency and Disclosure

Transparency and disclosure, both company (internal mechanism) and country level (external mechanism), are fundamental components of corporate governance, enabling the shareholders to keep well informed about the way the company is being managed and governed. The idea is to reduce the information asymmetry between the agent and the principal, thus mitigating the agency problem. The demands for greater transparency and disclosure span from emerging to developed markets as well as from individual companies to whole countries. Several institutions and companies such as Standard & Poor's study both country and company level improvements using different methods [see e.g. S&P Transparency and Disclosure Study (2003)]. Also the academic world has shown some interest: The already mentioned study of Berglöf and Pajuste (2005) examine the transparency and disclosure of 370 companies in Central and Eastern Europe. They conclude that while the extensiveness of the financial regulation concerning transparency and disclosure is at an adequate level, again the problem is the enforcement. They rather bluntly report: "the data shows a widespread non-

[5] For a wide coverage of international standards see European Corporate Governance Institute website: www.ecgi.org

disclosure of even the most basic elements of corporate governance arrangements".

As mentioned before, all too often all emerging markets are classified as a homogenous group of countries, without taking into account their different development stages. Some evidence of these geographical differences in transparency and disclosure practices is supplied by Patel, Balic and Bwakira (2002), who analyze transparency and disclosure in emerging markets by studying 354 firms in 19 emerging markets. They find significantly higher transparency in the Asian emerging markets and in South Africa compared to the Latin American, Eastern European and Middle Eastern emerging markets. They also find support for higher valuation associated with better transparency and disclosure.

The two main effects of higher transparency and disclosure are the lower cost of capital for the company (higher firm valuation) and the magnitude of market reaction to company news (volatility). These are important factors for emerging economies, which are especially keen to attract new investors and lower the cost of capital for the firms.

Diamond and Verrechia (1991) support the theory that better transparency leads to lower cost of capital. They argue that reducing information asymmetry with better transparency and disclosure reduces the cost of capital by attracting increased demand from large investors. This is also supported by Gelos and Wei (2002), who conclude that in general international funds prefer more transparent markets. Higher disclosure and better accounting standards can also help to avoid insider trading and market manipulation. The findings of Lee and Ng (2004) support this. They find that companies from more corrupt countries trade at significantly lower market multiples. Further support is given by Chen, Chen and Wei (2003), who examine the effects of disclosure on the cost of equity with a sample of 545 companies from Asia's emerging markets ranked by Credit Lyonnais Securities Asia (later referred to as CLSA) based on the companies corporate governance practices. Chen, Chen and Wei also find a negative correlation between disclosure

and the cost of capital: Their rough estimation is that, if a firm improves its corporate governance ranking form the 25th percentile to the 75th percentile, its cost of capital can be reduced by 1,26 percentage points. However, they also conclude that after controlling for other corporate governance mechanisms (such as country level legal protection of shareholders) the negative correlation of disclosure and cost of capital is weaker.

The second effect of better transparency and disclosure is the market reaction to news. Furman and Stiglitz (1998) argue that the mean of investors' expectations is unlikely to be affected by a lack of transparency. However the variance of expectations is likely to be higher. This would imply that there are enough well informed investors to keep the mean reaction stable, but also a large number of poorly informed investors, who cause unnecessary volatility to the market.

2.3 Internal Mechanism – Ownership Concentration

Ownership concentration has been seen as one of the strongest mechanism of corporate governance. However, the effects of concentrated ownership are not so straightforward. The basic theory is presented by Grossman and Hart (1986), who argue that if ownership is widely dispersed, no individual shareholder will have the incentive to monitor managers since each will regard the potential benefit from a takeover to be too small to justify the cost of monitoring. Thus a strong owner, who has enough incentives to do the monitoring, should improve firm governance.

While this monitoring reduces agency problems between the management and the controlling shareholder, the interests of the different shareholders might not be aligned. This is the argument of LLSV.

LLSV (1999a) study corporate ownership patterns around the world in 27 of the wealthiest economies and concluded that the ownership pattern differed from the one described by Berle and Means (1932) in their classic " The Modern

Corporation and Private Property". Berle and Means describe the ownership of capital as dispersed between small shareholders and the management. The practice however, especially outside the US, is different. LLSV find that particularly in countries with poor shareholder protection even the largest companies tend to have a controlling shareholder. This controlling shareholder might be the State or a family and typically has control over the firm in excess of cash flow rights owned. Sometimes this is accomplished by having two share classes, with different voting rights. The consequence of this is that the companies are run by controlling shareholders whose interest might not be aligned with the minority shareholders. The controlling shareholders have the power and means to expropriate the minorities and as a consequence equity markets with good legal protection of minority shareholders are broader and more valuable. LLSV continue stating that: "Restricting the expropriation of minorities by the controlling shareholders is the real challenge to corporate governance in most countries".

Claessens, Djankov, Fan and Lang (1999) study ownership and firm performance of 2658 companies in nine East Asian countries. They find that higher cash-flow rights are associated with higher market valuation, but higher control rights are associated with lower market valuation, especially when cash-flow rights are low and control rights are high. This suggests expropriation of minority shareholders by controlling shareholders. Claessens et al. conclude that this expropriation of minority shareholders is the main corporate governance problem in these countries in line with the theory suggested by LLSV (1999a).

In his study of management ownership structures, large non-management block holders and their relation to firm value across a sample of 1433 firms from 18 emerging markets Lins (2003) also finds that when a management group's control rights exceed its cash flow rights the firm values are lower. He also finds that large non-management control rights block holdings are positively related to firm value. Both of these effects were significantly more pronounced in countries with low shareholder protection.

While the expropriation of minorities is one of the main problems in emerging markets, there are also documented positive effects of concentrated ownership along the lines of the theory from Grossman and Hart (1986). The studies from Claessens and Djankov (1999a, 1999b) and Claessens, Djankov and Pohl (1999) find positive effects of ownership concentration in emerging markets when studying the ownership of companies in the Czech Republic after the voucher privatization. They conclude that while concentrated ownership is associated with higher valuation and profitability, even larger positive effects were found when this controlling shareholder was either a bank sponsored (privatization) fund or a strategic investor.

The type of controlling shareholder was also significant in the study of the Chinese mark of Xu and Wang (1999). They find evidence supporting the importance of large institutional shareholders and problems with overly dispersed ownership structure. In addition they find the inefficiency of state ownership.

The actual causes of ownership structure and changes in that structure after the privatizations are the focus of the paper from Jones, Kalmi and Mygind (2003). They study the effects of ownership changes in Estonia after the privatization and their effect to economic efficiency. They find that wealth and resource constraints play a crucial role in the determination of ownership, with foreigners buying with higher equity values and company insiders buying at lower equity valuations. They also find that risk aversion explains subsequent ownership changes e.g. from employee ownership to outsiders as insiders have the need to diversify their holdings.

2.4 Internal Mechanism – Board of Directors and Management

Board composition and its effects on company performance is a well studied topic in the developed markets. Hermalin and Weisbach (2003) review this literature. They summarize the findings as follows: Higher proportions of outside directors are not associated with superior firm performance, but with better decisions

concerning issues such as acquisitions, executive compensation and CEO turnover. Secondly board size is negatively related to general firm performance and the quality of decision making. The third finding is that poor firm performance, CEO turnover and changes in ownership structure are often associated with changes in the board membership.

In emerging markets the board's composition has not received much attention. This can be explained by the lack of publicly available information on board structures and decision making, but I also see the concentrated ownership structure playing a major role. Especially in the small former communist countries of Eastern European, the ownership of companies is extremely concentrated. In the extreme case the company insiders usually have three roles as the owners, as the managers and as the supervising board members. In these circumstances the companies resemble a closely held company, with the exception that the company insiders do not control the company 100% (rather 50% or less) and the minorities are the ones who might be getting the rotten deal. Again we end up to the theory that investor (minority) protection is the number one corporate governance issue in these markets.

CEO turnover and it's effects on company performance has similar problems as the board of directors, but to a lesser extent, as old managers (insiders) move to governing places and leave day to day business to more professional managers (outsiders). Among other things Claessens and Djankov (1999a, 1999b) study CEO turnover in the Czech Republic and find that it is associated with improvements in profitability and labor productivity. Claessens and Djankov claim that the Czech evidence is well suited for empirical testing of the importance of management turnover based on the following: first, the privatization process in the Czech Republic prevented incumbent managers from getting significant insider control. As a result, management changes and ownership were quite separate. Second, as compared to studies in developed countries, there were few managers with skills suited to a market economy in the Czech Republic at the start of transition and immediately following privatization.

While I agree with Claessens and Djankov that their study provides a study book example of management turnover and effects, I would also argue that the results cannot be generalized and applied in other former communist countries. The reason is the very same that made the Czech market suitable for this kind of a test: no other country used this voucher privatization method (to its full extent). The privatization methods used in other countries actually made it possible for insiders to acquire significant blocks of the companies, thus stagnating the board and management to some extent.

2.5 Internal Mechanism – Free Cash Flow and Dividend Policy

In developed markets the dividend policy and the rights to cash flow are seen as a part of corporate governance. The agency theory suggests that outside shareholders have preference for dividends over retained earnings, because insiders might waste cash retained within the firm. (see e.g. Easterbrook 1984, Jensen 1986, Myers 2000, LLSV 2000b).

For the same reason, and even more so, investors in emerging markets should be interested in the actual cash flow they receive from the companies as expropriation of retained earning is easier within the weaker legal frameworks of developing countries. Still the only relevant study in emerging markets is from Mitton (2004). His study involved dividend payout policies of 365 companies in 19 emerging market economies. His study shows that firms with stronger corporate governance have higher dividend payouts, consistent with the agency model of dividends.

2.6 General Studies

There are also several research papers, which do not focus on a particular aspect of governance, but rather try to give a more overall picture on the effects of good corporate governance to company market valuation or company performance.

Black (2001a, 2001b) uses a small sample of 21 of the largest companies in Russia and corporate governance ranking by an investment bank (Brunswick Warburg) to check for effects in company market value ratio. This value ratio was the ratio of the actual market capitalization of the Russian companies to the potential western market capitalization of the companies. These potential market values were independently determined by another investment bank. Black finds an 8-fold increase in market value for every one standard deviation improvement in the corporate governance ranking. A worst to best governance improvement predicts a 600-fold increase in firm value. While Black's study is only tentative due to the small sample size, it provides a benchmark for future research in extreme legal environments.

As with other emerging market corporate governance studies the Asian developing countries have received much more attention then their Eastern European counterparts. Durnev and Kim (2005) study why firms practice high-quality governance when law does not require this and the relation between firm valuation and corporate governance. Using a firm-level governance and transparency data on 859 firms in 27 countries, they find that firms with greater growth opportunities, greater needs for external financing, and more concentrated cash flow rights practice higher-quality governance and disclose more. Moreover, firms that score high in governance and transparency rankings are valued higher in the stock market than low scoring companies. Equally important, all these relations are stronger in countries that are less investor friendly, demonstrating that firms do adapt to poor legal environments to establish efficient governance practices.

Klapper and Love (2004) also use corporate governance rankings from CLSA across 14 emerging markets. They find that companies in countries with weak overall legal systems have on average lower governance rankings and that better corporate governance is highly correlated with better operating performance and market valuation. They also find that this relationship is stronger in countries with weaker legal systems, implying that companies can to some extent compensate for

the absence of strong laws and good enforcement, although this adjustment mechanism is a second best solution and does not fully substitute for the absence of a good legal infrastructure.

Black, Jang and Kim (2005) continue working with overall governance indices by constructing a corporate governance index of 515 Korean companies. They find a 0.47 fold increase in Tobin's Q value for a worst-to-best change. This corresponds to a 160% increase in share price. In contradiction with e.g. Klapper and Love (2004) Black et al. find that better corporate governance does not appear to predict higher firm profitability. In addition Black et al. state that it remains an open question to what extent the higher share price of better governed firms reflect an increase in total firm value, versus a decline in private benefits of control enjoyed by insiders previously.

3. Introduction to the Baltic Equity Market

The Baltic countries regained independence after the collapse of the Soviet Union in 1991.[6] This meant a new era for the countries, which had a tremendous task of rebuilding their economies on the basis of free economy after almost five decades of central planning. One of the first steps was the privatization of state owned enterprises, that eventually led to the creation of local securities markets. At first trading was done OTC, with physical share certificates and privatization vouchers, but in the mid 90's the three Baltic stock exchanges Tallinn, Riga and Vilnius were established.

In this chapter I will present the markets and discuss their development in the recent years. I will also discuss the privatization and current ownership structure as well as the legal framework governing listed companies as previous research has found these attributes having significance in corporate governance practices.

3.1 Overview

The Baltic equity markets are small compared to their Eastern European neighbors. The number of companies and the market capitalization of the listed companies is small and liquidity is generally poor. Despite the common trading platform, the Baltic exchanges have still only a few foreign investors and while the number of local institutions and investors is growing fast, they are limited in number and size. Table 1 presents the total market capitalization of listed companies in the three exchanges. Estonia's market capitalization is shown with and without Hansapank, which was originally listed in Tallinn mainly for historical reasons but the bank actually got over 50% of its turnover from the other Baltic States.

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[6] Lithuania was the first to proclaim independence already in 1990, but this was not recognized by the Soviet Union until August 1991.

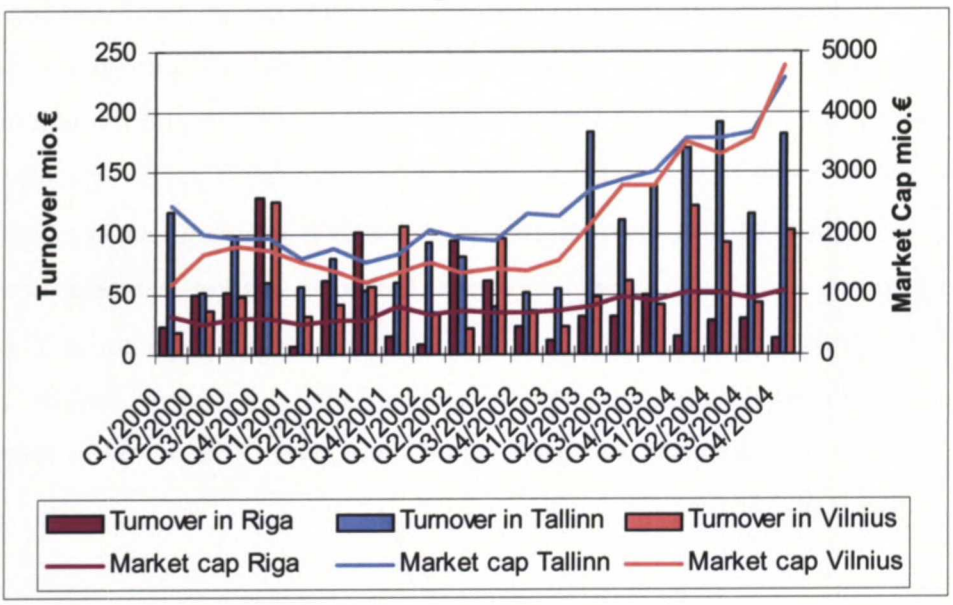
Table 1

The Baltic Market Structure as of 12/2004

	Number of companies		Market capitalization €
	Main List	I-/Current list	of listed securities
Estonia	7	6	4 626 477 012
Estonia (without Hansapank)	6	6	1 576 566 342
Latvia	4	8	1 207 220 016
Lithuania	8	35	4 754 832 065

The different speed of economic transformation from a centrally planned to a market economy strongly influenced the development of the local stock markets. Figure 1 presents the development of the exchanges in the last five years. Estonia was the first to have a functioning stock market with adequate liquidity to lure in even foreign capital, making the stock exchange a viable way for local companies to the gather fresh risk capital. Vilnius Stock Exchange in Lithuania has also grown and has nowadays a larger turnover and market capitalization than the Tallinn stock exchange.[7]

Figure 1
Quarterly turnover and market cap development Q1/2000 - Q4/2004



[7] After the delisting of Hansabank from the Tallinn Stock Exchange, subsequent to it's successful takeover by Swedens Swedbank

The Latvian stock market, on the other hand, has not developed and is by far the smallest with poor average liquidity. One of the main causes for this is the poor corporate governance records and practices of the listed Latvian companies, despite the stock exchanges efforts to improve this. One widely publicized case of corporate governance abuses included Laima's takeover of Staburadze in 2000.[8] Even the IPO of SAF Tehnika in 2004, which the local brokers described as the "Saviour of the Riga Stock Exchange", didn't blow enough wind to the Latvian exchanges sails and turnover has remained appalling. This means that Latvian companies are forced to find risk financing through other means, e.g. private equity or listings abroad.

For investors the last five years have been very positive as the returns have been impressive even in the Latvian market. Table 2 presents the actual yearly returns.

Table 2

Yearly stock returns in the Baltic States

RIGSE is the general index in the Riga stock, TALSE the Tallinn index and VILSE the index for Vilnius stock exchange.

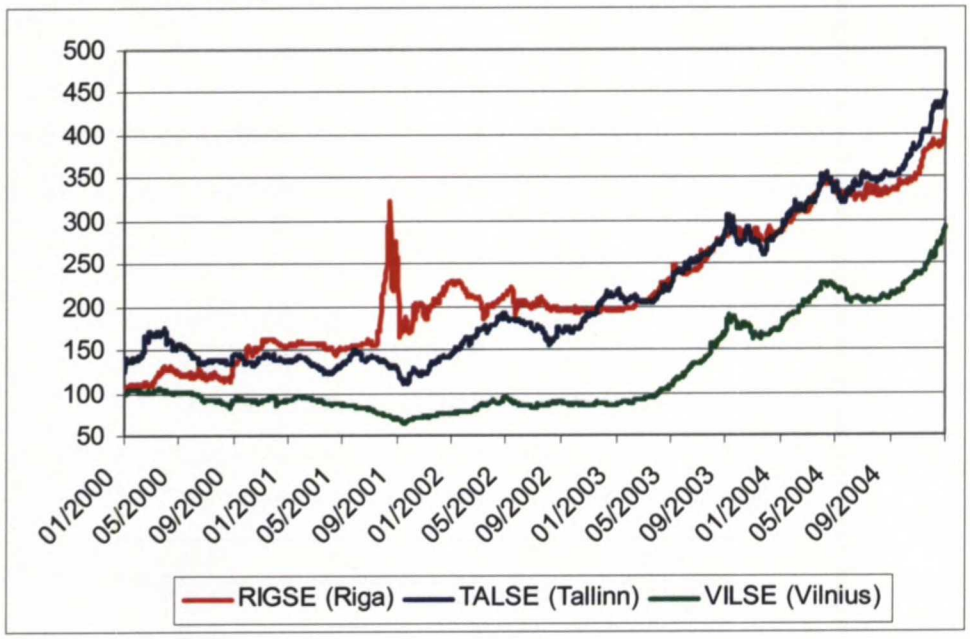
Year	Rigse	Talse	Vilse
2000	55,8 %	10,1 %	-7,3 %
2001	46,9 %	4,7 %	-18,5 %
2002	-14,3 %	46,8 %	12,2 %
2003	47,0 %	34,4 %	105,8 %
2004	43,5 %	57,1 %	68,2 %

[8] In November 2000, the Riga Stock Exchange (RSE) halted trading with the shares of a local candy and chocolate manufacturer Staburadze. This was after the company failed to provide information on a deal where Staburadze acquired shares of NTBDC L Ltd, a major shareholder of Laima, another Latvian candy maker. Staburadze failed to give information regarding financing sources of the acquisition and impact of the deal on Staburadze's financial indicators. Staburadze bowed and submitted the information, but requested the information be sealed. The RSE insisted this would hurt shareholder interests and asked the Securities Market Commission (SMC) of Latvia to intervene. The SMC later fined Staburadze for supplying false information. ROSC (2002)

Figure **2** shows the development of the local indices. It should be noted that because of the small size of the exchanges, the effect of single events can seriously influence the markets. For example during august 2001 the Latvian government's sale of 5% of Latvijas Gaze, which has a large weight in the Latvian index, resulted in a serious price hike in the local index.

Figure 2

The development of the local market indices 2000-2004



3.2 Privatization and Ownership Structure

The privatization method has been a large determinant of company ownership structures in all transitional economies. Although all privatization methods differed somewhat from each other, the two basic forms were vouchers and direct sales of companies.

Estonian privatization relied heavily on a direct sale of companies to outsiders through a Treuhandanstalt style privatization agency[9]. This resulted in a core investor model for almost all privatized companies. The core investor was usually either a foreign institution or the local management of the company (through a MBO). Privatization vouchers were also used but only to a small extent compared to other former communist states. Moreover, they were mainly used to privatize land and housing or to buy minority shares in companies, which already had a core owner (Mygind 1999).

Latvia started with small-scale decentralized privatization in 1992, but already in 1994 opted a privatization agency model. Although not as fast as Estonia, due to local political instability, the Latvian system still managed to privatize most of its companies in tender offers. This method also resulted in a core investor - ownership, with the difference to Estonia that there were fewer foreign investors involved. Vouchers were again only a secondary method and mainly used for land and minority shares (Mygind 1999).

Lithuania used a mass voucher privatization scheme privatization in 1991, even before the Czech Republic. This was later followed by direct sales (Mygind 1999). This resulted in a much broader ownership structure and also large-scale insider ownership of companies. The problem with broad ownership was that necessary company restructuring was often delayed, as there was no core owner to

[9] Treuhandanstalt was the privatization agency formed to privatize the state assets of the former East Germany.

do the dirty work. On the other hand, also the large employee ownership made it harder to implement restructuring plans that included mass lay offs. A special feature in the privatization process was the forced stock exchange listing of privatized companies, which resulted in a long line of listed companies in the Vilnius Stock Exchange.

Table 3 on the following page presents the current ownership structure of listed Baltic companies. The table is based on my own analysis on data from company annual statements and OMX. The results are mostly in line with previous research on Baltic ownership from Pajuste and Olsson (2001), except for somewhat higher values in my analysis for 2nd and 3rd largest shareholders. This is partly explained by the time difference of the samples as well as the sample size, which in Pajuste and Olsson's paper was larger and included more non-listed companies which tend to have only one main owner. To give a better picture of the ownership concentration I have also included a category for blockholders above and less than 5% ownership. Shareblocks of over 5% tend to be significant enough in proxy fights, while blocks less than 5% can be considered true minority investments, with no strategic meaning.

The major difficulty in the analysis of raw data from annual statements and OMX is the identification of the ultimate owner. Unfortunately large foreign mutual funds are not shown in these data sources under their own name, but rather under the name of the custodian bank (e.g. ING Lux, Okobank Clients, SEB Clients). Another problem are offshore accounts or holding companies, which were frequently used in the past by company insiders to control the companies. In my analysis I have tried to take into account these problems and I have made several adjustments to the raw data accordingly.

Table 3

Ownership structure of listed companies

Largest, 2nd and 3rd largest owner refers to a single owner, entity or group of owners, who control the largest, 2nd or 3rd largest block of shares in the company in question respectively. Other (above 5%) refers to the combined ownership of other owners, who control over 5% of sharecapital. Other (less than 5%) refers to minority shareholders with holdings less than 5% of sharecapital. No. of observation refer to the number of observations in that particular category e.g. There are 9 companies in Estonia, where there is a 2nd largest blockholder holding above 5% of shares.

Estonia	Largest owner	2nd largest owner	3rd largest owner	Other (above 5%)	Other (less than 5%)
Mean ownership	57,87 %	15,17 %	6,95 %	12,72 %	23,04 %
Median ownership	55,24 %	11,07 %	6,65 %	11,64 %	24,05 %
Min ownership	24,40 %	7,80 %	5,01 %	5,20 %	4,26 %
Max ownership	95,74 %	27,17 %	10,00 %	22,40 %	44,79 %
No. of Observations	12	9	6	4	12

Latvia	Largest owner	2nd largest owner	3rd largest owner	Other (above 5%)	Other (less than 5%)
Mean ownership	46,79 %	22,23 %	13,00 %	13,91 %	23,62 %
Median ownership	48,00 %	22,50 %	9,74 %	14,79 %	16,43 %
Min ownership	17,05 %	9,85 %	8,00 %	8,12 %	2,77 %
Max ownership	87,98 %	38,60 %	25,00 %	18,83 %	50,14 %
No. of Observations	12	10	7	3	12

Lithuania	Largest owner	2nd largest owner	3rd largest owner	Other (above 5%)	Other (less than 5%)
Mean ownership	57,59 %	14,90 %	10,43 %	19,26 %	20,64 %
Median ownership	53,70 %	12,04 %	9,93 %	19,01 %	17,32 %
Min ownership	9,81 %	4,56 %	5,11 %	6,25 %	0,32 %
Max ownership	99,40 %	40,66 %	17,95 %	35,48 %	73,88 %
No. of Observations	43	34	19	12	43

The current ownership structure of Baltic companies is very concentrated. The largest owners own on average over 55% of shares in Estonia and Lithuania and somewhat less in Latvia. The 2nd largest blockholders tend to own 10% - 20%, the 3rd largest 7%-13% and the small blockholders (above 5%) hold another 10% - 20%. The minorities with less than 5% of shares own approximately only 20% of the company. Even in Lithuania, where the privatization made a broad ownership structure possible, the largest owners block holdings are comparable by size to the other Baltic countries. As a comparison, in their research Maury and Pajuste (2002) report an average ownership of the largest owner in Finland to be around 32,5% and the 2nd largest holdings of 9,7%, which are both significantly lower than in the Baltics.

The 50% mark is a critical level in Estonia and Latvia and 40% in Lithuania as they are the thresholds for mandatory takeover bids.[10] This means that an investor who acquires more than 50% / 40% of shares has to make a takeover offer for the rest of the shares. The reason why the average holdings in Estonia are above 50% can partly be explained by the numerous exceptions to the Mandatory bid rule, that somewhat undermine its effectiveness (Berglöf and Pajuste 2003). In Lithuania the average is being pushed upwards by the large ownership of the Lithuanian state and State Property Fund, which are the largest owners in eight Lithuanian companies with an above average shareholdings (e.g. Lietuvos Energija 96,62%). In Estonia and Latvia the state is no longer the biggest block holder in any of the listed companies. This is also due to the fact that some of the largest old government monopolies in Estonia and Latvia such as Eesti Energia or Latvian Telecom have not been listed, unlike in Lithuania.

The investor type is also an important factor as is shown is several previous studies [see e.g. Xu and Wang (1999), Claessens and Djankov (1999a, 1999b) and Claessens, Djankov and Pohl (1999)]. Table 4 presents the type of the major owners in the Baltics based on my analysis. In the table I have classified the largest and 2nd largest shareholders into eight categories. Due to the difficulties in analyzing the data reliably I have excluded smaller ownership positions (3rd/4th), because they are more vulnerable to misclassification. Especially in the case of foreign investment funds, which as mentioned before, are not represented in the public lists under their own name, but rather under the name of the custody bank. If the custodian has also other clients under the same account, my analysis will overestimate the ownership of that particular investment fund. This is not a big problem in the larger positions, where the funds, according to their own disclosure, own the vast majority part of the position. However in the smaller positions the possible effects of retail clients using the same custody might cause significant overestimation problems.

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10 According to the new Lithuanian law effective from 1 January 2005. In Latvia also 75% is a threshold.

Table 4

Type of major investors

Based on interviews with several survey participants I have collected a rough estimation of the owner type of the largest and 2nd largest shareholders in the Baltic countries. Because of the difficulties in analyzing the data reliably I have excluded the smaller positions (3rd and 4th largest shareholder types), which are more vulnerable for misclassification. The number refers to the total number of such investors holding the largest/2nd largest position in a company. For example in Estonia 4 companies have company management as the largest owner and in one company management is the second largest owner. Foreign/local strategic owner category refers to all foreign/local companies, which hold a strategic stake in the company. Financial institutions such as investment fund/companies are presented as a separate category. Local Private refers to local private individuals.

Estonia (12 Companies)	Largest owner	2nd largest owner
Foreign Investment Funds	-	6
Local Investment Funds/Companies	3	-
Company Management	4	1
Foreign Strategic Owner	5	-
Local Strategic Owner	-	-
State or Privatization Agency	-	1
Local Private	-	-
Others / Unknown	-	-

Latvia (12 Companies)	Largest owner	2nd largest owner
Foreign Investment Funds	-	1
Local Investment Funds/Companies	-	-
Company Management	3	1
Foreign Strategic Owner	4	1
Local Strategic Owner	3	-
State or Privatization Agency	-	2
Local Private	2	2
Others / Unknown	-	-

Lithuania (43 Companies)	Largest owner	2nd largest owner
Foreign Investment Funds/Companies	6	12
Local Investment Funds/Companies	10	4
Company Management	7	9
Foreign Strategic Owner	7	4
Local Strategic Owner	2	-
State/Public or Privatization Agency	8	2
Local/Foreign Private	1	-
Others / Unknown	2	-

According to the data, all Estonian companies are in the hands of foreign strategic owners, foreign investment funds or local management. In most cases the 2nd largest owner is a foreign investment fund. The state is a small owner in only one stock: Estonian Telecom. In Latvia the major owner is often a foreign company,

the management or another local company. In addition several wealthy individuals hold large positions. The 2nd largest shareholders include among others the Latvian state. Foreign investment funds hold a 2nd largest position in only one company. Compared to its neighbors the Lithuanian ownership is much more diverse, including owners in all categories. The largest differences to the other Baltic States are the large state/municipality ownership: In total 10 companies have significant state ownership. The other major difference is the large number of companies held by local financial institutions. Local investment companies own significant stakes in 14 firms. The actual number of investment companies is actually small, but some of the most high profile ones own significant stakes in several listed companies. In addition to local ownership, many companies have large foreign investment funds and foreign companies as their owners.

3.3 OMX Stock Exchanges

The three Baltic stock exchanges are now part of the Scandinavian OMX Group and they share a common "SAXESS" trading platform with their Scandinavian neighbors. OMX has also introduced common disclosure requirements for listed companies to standardize transparency. Surprisingly, the exchanges still lack a common corporate governance code. Lithuania has had a governance code for several years already, but it has never been enforced successfully. Only in September 2005 did OMX publish a code for Estonia, while Latvia is still without one.

I confronted Mr. Gert Tiivas (Interview 8.11.2005) from OMX Group in relation to the governance codes. Mr. Gert Tiivas is the former Senior Vice President of HEX Baltic Operations business unit and currently acting as the President of Growth Markets in the OMX Group. I asked Mr. Tiivas why OMX still has not introduced a Baltic wide governance code. According to Mr. Tiivas a universal governance code is a long-term plan, but it will take some time to implement due to the different starting points of the exchanges and due to legal and regulatory differences still in place. He continued that while the EU harmonized a large part

of the legislation, commercial and company laws still differ somewhat from country to country. As an example the decision making level in companies differ: Some of the countries recognize a 1-tier some a 2-tier management board structure. If one then were to issue e.g. guidelines stating a designated number of independent board members in company management one would also have to define in which board level this should be implemented. Basically this means that a very specific unified governance code is impossible to introduce. OMX has recognized this and is aiming for some sort of unified generic principles, without any detailed requirements. Mr. Tiivas commented that the new Estonian guidelines may act as a starting point or as a benchmark, into which the Latvian and Lithuanian codes will probably be based. Of course OMX will also follow international guidelines such as the OECD principles. On the timetable of these plans Mr. Tiivas expects the new codes for Latvia and Lithuania to be introduced during 2006.

In the past one of the largest problems in the Baltic markets has been the non-compliance of companies even to the existing rules and regulations. Normal stock exchange procedures dealing with non-compliance of the listed companies include fines, warnings, admittance to a watch list and reference to the local market supervisor. The ultimate sanction is a forced delisting, which has happened only once in Estonia. However as Mr. Tiivas pointed out, a delisting will only further worsen the situation of the minority shareholders and is therefore a last resort in the stock exchanges methods.

The non-compliance of stock exchange rules in most cases has to do with the lack of continuous disclosure including reporting of significant events such as profit warnings. According to Mr. Tiivas, while disclosure practices have improved in the last years, this has been a slow process and it will still take a lot of time to reach western levels as the process includes changing company and business culture. As previously mentioned, Lithuanian companies were forced to get listed after their privatization, which means that their willingness to comply with new extensive disclosure requirements might not be very good. Mr. Tiivas pointed out

that the Baltic markets are to a large extent investor driven: The companies have not seen value added in implementing better governance, because they are not dependent on investor financing. Unless the major owners of the companies demand action in this regard, the process will be painfully long. Still even this might not be enough as some companies e.g. in Lithuania have a free float of less than 5%, which is hardly enough to force companies into better governance. In these cases the responsibility lies with the majority owners whether private or the state. Nevertheless, the OMX feels responsible to be the initiator of this improvement process. Nowadays the larger companies with wider ownership structure already understand the benefits of having the stock exchange as an option to get new financing and act accordingly. Some companies have also implement industry "Best Practices" guidelines and Mr. Tiivas expects this process to continue.

3.4 Legal and Regulatory Framework in the Baltics

The legal systems of Estonia and Latvia are based on the continental European system, i.e. civil law. This means that legislative acts are the most important source of law, while doctrine, precedents and customary practice are of secondary importance. The Lithuanian system is also based on the continental system, with the small deviation that unwritten sources do not play any important role as sources of law. With the EU membership, the Baltic countries have also adapted the EU wide directives, which harmonize the written law even further with Western Europe. However, as was noted earlier, the enforcement of laws and regulations (the effectiveness), in transition economies usually lag behind the extensiveness of the law. Researchers from the Worldbank [Kaufman, Kraay and Mastruzzi (2005)] have created six Governance indicators of which Table 5 on the following page presents two: Rule of Law and Control of Corruption. Rule of Law measures the quality of contract enforcement, the effectiveness of the police and the courts as well the likelihood of crime and violence. Control of Corruption measures the exercise of public power for private gain including state capture.

These two estimates can be used as a proxy for the efficiency of the legal and regulatory system.

Table 5

Governance scores for "Rule of Law" and "Control of Corruption" 1998-2004 for selected countries

Rule of Law measures the quality of contract enforcement, the police and courts, Control of Corruption measures the public power for private gain, including state capture. Estimates vary from [-2.5] to [+2.5], where a higher score refers to higher Governance standard. Standard deviation (S.D.) is also reported. (N) Refers to number of sources for that particular estimates. The survey participants include international organizations such as the EBRD. Source: Kaufman et al. (2005)

Rule of Law [-2,5 to +2,5]

	1998			2000			2002			2004		
	Estimate	S.D.	N.	Estimate	S.D.	N.	Estimate	S.D.	N.	Estimate	S.D.	N.
Estonia	+0.54	0.18	9	+0.71	0.13	13	+0.78	0.12	14	+0.91	0.12	15
Latvia	+0.08	0.18	9	+0.24	0.14	10	+0.42	0.13	12	+0.48	0.12	13
Lithuania	+0.19	0.18	9	+0.25	0.14	12	+0.45	0.13	13	+0.60	0.12	14
Hungary	+0.78	0.15	12	+0.84	0.13	14	+0.84	0.12	15	+0.85	0.11	16
Poland	+0.57	0.15	12	+0.62	0.13	14	+0.58	0.12	16	+0.51	0.11	16
Czech Rep.	+0.62	0.15	12	+0.59	0.13	13	+0.69	0.12	14	+0.69	0.11	15
Slovakia	+0.13	0.17	10	+0.30	0.13	12	+0.35	0.12	13	+0.49	0.12	14
Slovenia	+0.91	0.18	8	+0.87	0.13	12	+1.06	0.12	14	+0.93	0.12	15
Finland	+2.06	0.19	9	+2.11	0.16	11	+1.96	0.13	12	+1.97	0.13	11
Greece	+0.66	0.19	9	+0.73	0.16	9	+0.77	0.13	11	+0.75	0.13	11

Control of Corruption [-2,5 to +2,5]

	1998			2000			2002			2004		
	Estimate	S.D.	N.	Estimate	S.D.	N.	Estimate	S.D.	N.	Estimate	S.D.	N.
Estonia	+0.49	0.16	8	+0.78	0.14	12	+0.72	0.13	12	+0.82	0.12	13
Latvia	-0.10	0.16	8	+0.04	0.15	9	+0.09	0.14	10	+0.23	0.13	11
Lithuania	+0.07	0.17	7	+0.29	0.14	12	+0.26	0.13	11	+0.36	0.12	12
Hungary	+0.69	0.14	11	+0.78	0.13	14	+0.59	0.13	13	+0.65	0.12	13
Poland	+0.49	0.14	10	+0.49	0.13	14	+0.40	0.13	13	+0.16	0.12	14
Czech Rep.	+0.35	0.14	10	+0.40	0.14	13	+0.36	0.13	12	+0.30	0.12	13
Slovakia	-0.08	0.15	8	+0.27	0.14	11	+0.29	0.13	11	+0.39	0.12	11
Slovenia	+0.83	0.17	6	+1.10	0.14	11	+0.91	0.13	12	+0.97	0.12	12
Finland	+2.55	0.18	8	+2.56	0.18	9	+2.45	0.16	9	+2.53	0.15	10
Greece	+0.85	0.18	8	+0.82	0.18	8	+0.58	0.16	9	+0.56	0.15	10

Generally the new EU-members are behind the old member countries in governance, but they are catching up fast. Finland along with other Scandinavian countries represent to most law abiding and least corrupt societies in Europe, while Estonia, Hungary and Slovenia already scored higher than Greece, which has the worst rankings along with Italy among the old EU members. Estonia's rapid progress can be attributed to its reform team, which consisted of economic and political experts who were capable of translating policy advice into actual policy making and relative political stability, which made implementing the

reforms possible. Of course the small size of the country and relatively homogenous population, was also an important factor. Especially Latvia and Lithuania lag behind in the level of corruption: Corruption still plagues the countries, although the situation has improved to some extent during the last couple of years.

The Baltic financial sector is regulated by market regulators: Financial Supervision authority (FSA) in Estonia, The Finance and Capital Markets Commission (FCMC) in Latvia and The Securities Commission in Lithuania. The market regulators are independent government regulatory bodies, which supervise and license the financial institutions working in their respective areas of jurisdiction. They also aim to enhance stability, transparency and efficiency of the financial sector.

Because of its importance, financial regulation and commercial law was among the first to be reformed after the collapse of the Soviet Union. Table 6 presents the findings of EBRD's Transition Report (Berglöf and Pajuste 2005). In most of the Eastern European countries the extensiveness of commercial law and financial regulation was good already in 1998, while again the effectiveness was lagging behind.[11] Since the late 90's, progress has been made and commercial law enforcement can be considered adequate. The next step is to also improve the enforcement of financial regulations. According to Pajuste (2002) a weak factor in Estonia and Latvia in 2000 was the disclosure and transparency of information. This includes the voting power of controlling owners, the true nature of concerted action (e.g. voting agreements, corporate linkages), as well as the true identity of an offshore entity.

[11] There are, however, still differences in laws as mentioned by Mr. Tiivas and some of the laws actually cause serious problems to investors (see chapter 6 for examples).

Table 6

Commercial law and Financial Regulation in Eastern Europe

Ratings from [1] to [4], the higher the better. Source: Berglöf and Pajuste (2005) from EBRD Transition Report (2000, 2002)

	Commercial Law						Financial Regulation					
	Extensiveness			Effectiveness			Extensiveness			Effectiveness		
	1998	2000	2002	1998	2000	2002	1998	2000	2002	1998	2000	2002
Estonia	3	3,7	3,7	4	3,3	4	3,3	4	4	2,7	2,7	3
Latvia	3,3	4	3,7	2	3,7	3,3	3,3	3	4	2,3	3	3,7
Lithuania	4	4	3,7	3	3,3	3,7	2,7	4	3,7	2	3,7	3
Bulgaria	4	4	3,7	4	3,7	4	4	3	3	3	2,3	3
Czech Republic	4	3	3,7	4	3,3	3,7	3,3	4	3,3	2,7	2,7	3
Hungary	4	4	3,7	4	3,7	3,7	4	4	3,3	4	4	3,7
Poland	4	3,7	3,3	4	4	3,7	4	4	3,7	3	4	3,3
Romania	4	3,3	3,7	4	3,7	4	3	4	3,7	2,7	3	3
Slovak Republic	3	3	3	2	3	3,3	3	3	3	2	2,7	2,3
Slovenia	3	4	3,3	3	3,7	3,7	3,3	4	3,3	2,7	4	3
Average	3,63	3,67	3,55	3,4	3,54	3,71	3,39	3,7	3,5	2,71	3,21	3,13

Transparency and Disclosure requirements also differ among the Baltic countries. The requirements are nowadays based on the EU directive, but the enforcement of these requirements makes a large difference. Table 7 presents the findings of Berglöf and Pajuste (2005). The results imply that the lack of enforcement is a common problem in Eastern European markets. While Lithuania scores the highest in disclosure requirements, the actual enforcement is so poor that it falls behind Estonia and the Czech Republic, where the companies do a lot voluntary disclosure. Among the Baltic countries Latvia scores the lowest in both required disclosure and actual disclosure. In fact its actual disclosure score is between Romania and Bulgaria, which are not even EU members yet. The Slovak Republic and Slovenia, which score poorly in Annual report disclosure, compensate this with good Website disclosure, while Latvia and Lithuania have a less than average Website disclosure score.

Table 7

Transparency and Disclosure in Eastern Europe

A higher score implies more disclosure. Actual Annual Report Disclosure measures the actual amount of information in the annual reports of the companies, while the Required by Law score refers to the amount of information that should be presented in the annual statements. Negative Difference score implies less disclosure than required by law. Web disclosure is an aggregate measure of the information supplied in the company website. Source: Berglöf and Pajuste (2005)

Country	Annual Report Disclosure			Web Disclosure
	Actual	Required by Law	Difference	
Bulgaria	1,5	2,5	-1,00	0,86
Czech Republic	2,81	2,5	0,31	3,53
Estonia	2,86	2,5	0,36	2,23
Hungary	1,63	1,5	0,13	2,71
Latvia	1,44	1,5	-0,06	1,82
Lithuania	2,31	3	-0,69	1,53
Poland	1,62	2	-0,38	2,51
Romania	1,38	1,5	-0,12	1,37
Slovak Republic	1,5	1	0,50	3,4
Slovenia	1,86	2	-0,14	3,05
Total	2,08	2,22	-0,14	2,26

While the Baltics have developed during the last years, especially Latvia and Lithuania should focus more on the control of corruption, because this plays an essential part when improving the enforcement of other laws. While the major media interest is focused on high profile countrywide corruption cases, I believe the focus should also be directed into lower government levels. For example one survey participant especially criticized regional governments and city officials in Latvia for widespread corruption.

4. Hypothesis

In this chapter I will present my hypothesis for the quantitative part. The chapter is divided into four parts according to the hypothesis focusing on firm valuation, firm performance, dividend policy and transparency and disclosure.

4.1 Corporate Governance and Firm Valuation

For company valuation purposes I use Tobin's Q, defined as the company's market value divided by the value of its assets. This method is consistent with previous studies (see e.g. Black, Jang and Kim 2005).

According to theory, better corporate governance should lead to lower cost of capital and higher company valuation. This is consistent with the empirical evidence from Klapper and Love (2004), Black (2001a, 2001b) and Black, Jang and Kim (2005) and Durnev and Kim (2005), who all discovered a higher valuation for companies that had a better corporate governance overall index score.

Hypothesis 1: Higher overall corporate governance score leads to higher valuation (Tobins Q)
Expected sign: +

Based on previous research better transparency and disclosure should also lead to higher valuation of companies. [Diamond and Verrechia (1991), Patel, Balic and Bwakira (2002), Chen, Chen and Wei (2003)]. The theory is based on the notion that by reducing information asymmetry the cost of capital should become lower as investors are more willing the invest in the company.

Hypothesis 2: Higher transparency and disclosure score leads to higher valuation (Tobins Q)
Expected sign: +

The theory of the effect of ownership concentration is mixed. On one hand concentrated ownership means that the company has a controlling owner, who takes on the responsibility of governing the company. According to the theory this should lower the cost of capital. Claessens and Djankov (1999a, 1999b), Claessens, Djankov and Pohl (1999) and Xu and Wang (1999) provide evidence of higher valuation associated with a controlling shareholder. On the other hand as LLSV point out, the interests of this controlling shareholder and minority shareholders often do not align. This can lead to expropriation especially in emerging markets with poor investor protection. Because the ownership of the Baltic companies is very concentrated, I will first measure the effects of a company having a dominant largest shareholder (over 40% / 50% of shares). The argument supporting these high shareholding requirements is the requirement of relative strength of the major shareholder against the minorities: Due to the concentrated ownership, if the dominant owner wants to control a company, he or she has to control a larger share of the control rights than in the more developed countries with less concentrated ownership. E.g. a dominant owner with 30% could be pushed aside by a small number of other large shareholders, which might jointly control more than the dominant owner. Whether we hypothesize that a controlling owner is needed to lower the cost of capital or that a dominant owner steals from the minorities, both theories require the largest owner to be a dominant one. This is something that the 40% / 50% mark secures.

Hypothesis 3: Higher ownership concentration score (largest owner owns over 40% / 50%) leads to higher valuation (Tobins Q)
Expected sign: +

It can also be argued, that because there are different minority protection mechanism even in the Baltics, the largest owners tend not to use their power to expropriate, because of the fear of minority action against them. However, most of these minority protection mechanisms especially in Estonia and Latvia require a certain minority ownership (usually 10%), which entitles the minority holder to demand special audits call a meeting of shareholders etc. To put it another way, if

the majority owner has over 90% of the shares, he can usually work more freely without an imminent fear of successful minority action. Therefore I would argue that an ownership of over 90% could lead to expropriation and lower valuation.

Hypothesis 4: Very high ownership concentration (largest owner owns over 90%) leads to lower valuation (Tobins Q)
Expected sign: -

4.2 Corporate Governance and Firm Performance

In addition to higher company valuation, good corporate governance has also been associated with better firm performance. Consistent with previous studies (e.g. Klapper and Love 2004) I shall use ROA for performance measurement.

Consistently with previous findings of Klapper and Love (2004), I expect good overall corporate governance to be associated with better firm performance.

Hypothesis 5: Higher overall corporate governance score are positively correlated with better operating performance (ROA)
Expected sign: +

Clasessens and Djankov (1999a, 1999b) go further and link better company performance with higher ownership concentration. Their theory is based on the dominant owners possibilities to increase company efficiency by making tough decisions.

Hypothesis 6: Higher ownership concentration (dominant owner owns over 40% / 50%) is positively correlated with better operating performance (ROA)
Expected sign: +

4.3 Free Cash Flow Hypothesis and Dividend Policy

According to Jensen and Meckling (1976) cash flow ownership by an entrepreneur reduces incentives for expropriation and raises incentives to pay out dividends. Because in the Baltics the dominant owner is usually involved in the management of the company, the hypothesis is relevant. However, another point of view is that a dominant owner has other means of collecting the company's cash flows than dividend payout. This would imply that companies with high ownership concentration pay fewer dividends as the owners can expropriate more freely.

Hypothesis 7: Higher ownership concentration (over 40%, 50% and 90%) is positively correlated with dividend payouts
Expected sign: +

Mitton (2004) finds evidence of stronger corporate governance and higher dividend payout policy. I will also test the relation of higher investor rights score to dividend policy.

Hypothesis 8: Higher overall corporate governance (investor rights) score is positively correlated with dividend payouts
Expected sign: +

4.4 Transparency and Disclosure

Based on Furman and Stiglitz's (1998) research, I expect better transparency to be associated with lower volatility, as the market can value the shares based on facts not rumors.

Hypothesis 9: Better transparency is associated with lower volatility
Expected sign: -

Previous studies [see e.g. Berglöf and Pajuste (2005)] have found that higher ownership concentration is linked with lower transparency. The theory is based on the fact that the dominant shareholders receive the information they needs though other than public channels, so there is less need for public disclosure.

Hypothesis 10: Higher ownership concentration leads to lower transparency and disclosure.
Expected sign: -

5. Data and Methodology

In this chapter I will present the data and methodology of the study. Additionally I will discuss some of the problems associated with this research, including endogeneity of several variables.

Many similar corporate governance studies [see e.g. Black, Jang and Kim (2005) and Chen, Chen and Wei (2003)], which try to asses the effects of good governance to company valuations or performance, rely on a questionnaire survey sent to the companies or other types of company surveys conducted by a third party. The companies are then rated according to their answers such as description of voting practices in shareholder meetings etc. However, in transitional markets, this approach is usually somewhat fruitless. First of all the transparency and disclosure practices are at a lower level then in the Western markets. This includes investor relations: Some companies do not answer any questions let alone meet with any potential or even existing shareholders. To avoid this kind of problems, some governance related studies only use large companies in their samples, because these companies tend to be more professionally managed (size selection). However, this results in a selection bias problem. Only those companies with better governance, transparency or large size answer the questions. This type of sample selection can potentially bias the estimation results. Also with the small markets such as Estonia and Latvia, the small number of companies that do answer questions might render the research totally irrelevant as the sample size becomes too small.

To minimize these problems, I will use outside assessments of the companies as the basis of my governance index. I requested local market participants including analysts, brokers and fund managers of the largest local banks and brokerage houses to assess local companies according to their perception. In addition I discussed about the ownership types of the main owners in the Baltic companies with several of the survey participants.

5.1 Data

This quantitative part of the study includes all the companies listed either in the main list or the second/current/I -list in the Estonian, Latvian and Lithuanian stock exchanges at 12/2004 excluding Hansapank, which was taken over by Sweden's Swedbank during the spring of 2005, prior to the sending of the questionnaires and interviews. A complete list of the 67 companies and a short description of their activities can be found in Appendix 1. Ownership structure data is gathered from relevant company annual statements and OMX Group registries. Financial statements data is gathered from company 2004 annual statements. If the accounting period of the company was different from the calendar year, the latest audited statements were adjusted with quarterly data to make them comparable.

The Governance index is a combination of three sub assessments. The sub assessments evaluate the company's governance practices in management quality, transparency and level of investor protection. The survey assessments were made by 13 representatives of some of the largest Baltic banks, brokerage houses and investment funds.[12] Table 8 presents the geographical and main work area distribution of the participants. The participants also answered to several open ended questions, which are used in the qualitative part to identify the key problem areas of governance in the Baltics. The questionnaire can be found in Appendix 1. The Governance index scores for individual companies can be found in Table 9 on the following page.

Table 8

Description of questionnaire participants

The table presents short description of the participants in the governance survey including main work area and country of origin.

	Estonia	Lithuania	Latvia	Finland	USA
Broker	3	2			
Fund Manager	1	2		2	1
Others	1		1		

[12] The questionnaire was sent by e-mail to a total of 20 market professionals working with Baltic markets.

Table 9

Company Corporate Governance assessments

The table presents the results from the quantitative company assessments done by the survey participants. Observations (OBS) refer to the amount of assessments done on the company. The three elements are Quality of Management and Board, Investor Rights and Transparency and Disclosure. The mean score is used to create the overall Governance index with equal weights on the three dimensions. Standard deviation of assessments is also reported.

		Quality of Management and Board		Investor Rights		Transparency and Disclosure		
Company	OBS	Mean	St. Dev.	Mean	St. Dev.	Mean	St. Dev.	Governance Index
ESTONIA								
Baltika	9	2,89	1,10	2,78	1,13	2,89	1,29	2,85
Eesti Telekom	9	3,89	0,74	4,11	0,87	4,33	0,94	4,11
Tallinna Kaubamaja	8	3,50	0,87	3,63	0,86	3,63	0,70	3,58
Harju Elekter	8	4,00	0,71	4,13	0,78	3,75	1,20	3,96
Merko	8	4,00	0,50	4,13	0,60	4,13	0,60	4,08
Noma	9	3,44	0,50	3,33	0,67	3,56	0,83	3,44
Kalev	8	1,75	0,43	1,63	0,70	1,50	0,71	1,63
Klementi	7	2,71	0,88	3,00	1,20	2,71	0,88	2,81
Rakvere Lihakombinaat	7	2,71	0,45	3,00	0,53	2,86	0,64	2,86
Saku Õlletehas	8	3,75	0,66	4,13	0,60	4,13	0,60	4,00
Tallinna Farmaatsiatehas	8	1,50	0,50	1,25	0,43	1,38	0,70	1,38
Viisnurk	8	2,13	0,60	2,25	0,83	2,00	0,71	2,13
Average		***3,02***		***3,11***		***3,07***		***3,07***
Standard deviation		***0,88***		***1,00***		***1,02***		***0,96***
LATVIA								
SAF Tehnika	8	3,75	0,66	4,00	0,71	3,63	0,70	3,79
Ventspils nafta	8	1,50	0,71	1,13	0,33	1,38	0,48	1,33
Latvijas Kuģniecība	6	1,83	0,90	1,50	0,76	1,50	0,50	1,61
Latvijas Gāze	6	3,83	0,69	3,67	0,75	3,17	0,69	3,56
Latvijas balzams	5	2,60	0,49	2,20	0,75	2,40	0,80	2,40
Ditton pievadķēžu rūpnīca	5	2,00	0,89	1,80	0,98	1,80	0,98	1,87
Grindeks	8	2,75	1,09	2,38	0,86	2,50	1,00	2,54
Liepājas metalurgs	7	2,14	0,35	2,14	0,64	2,14	0,64	2,14
Olainfarm	7	1,86	0,83	1,86	0,83	1,71	0,88	1,81
Rīgas kuģu būvētava (Riga Shipyard)	6	2,17	0,69	2,17	0,69	2,17	0,37	2,17
Rīgas Transporta flote (Riga Transport Fleet)	6	2,17	0,90	2,00	1,00	2,50	0,76	2,22
Valmieras Stikla Šķiedra (Valmiera Glass Fabrik)	6	3,33	0,75	3,67	0,47	3,50	0,76	3,50
Average		***2,49***		***2,38***		***2,37***		***2,41***
Standard deviation		***0,77***		***0,91***		***0,75***		***0,80***
LITHUANIA								
Ekranas	10	2,30	0,78	2,20	0,98	2,70	1,19	2,40
Lietuvos Telekomas	10	4,30	0,46	4,30	0,46	4,30	0,46	4,30
Pieno Zvaigzdes	10	3,30	0,46	3,10	0,70	3,30	0,64	3,23
Rokiskio Suris	10	2,90	0,83	2,90	0,94	2,90	0,83	2,90
Snaige	10	3,90	0,54	3,70	0,90	3,60	0,80	3,73
Utenos Trikotazas	10	3,30	0,64	3,30	0,64	3,30	0,64	3,30
Vilniaus Vingis	10	3,30	0,64	3,10	1,04	3,30	0,64	3,23
Vilniaus Baldai	9	3,33	0,47	3,56	0,68	3,44	0,83	3,44
Alita	6	3,00	0,58	2,86	0,64	2,86	0,64	2,90
Alytaus Tekstile	6	2,50	0,96	2,33	0,94	2,50	0,96	2,44
Anyksciu Vynas	6	2,67	0,47	3,00	0,58	3,17	0,37	2,94
Apranga	9	4,00	0,67	4,00	0,89	4,00	0,47	4,00
Bankas Nord/b Lietuva	6	3,17	0,37	3,00	0,00	3,33	0,47	3,17
Bankas Snoras	7	2,43	0,90	2,29	0,70	2,71	1,03	2,48
Dvarcioniu Keramika	6	2,50	0,50	2,67	0,47	2,43	0,90	2,53
Grigiskes	7	3,57	0,49	3,57	0,73	3,14	0,64	3,43
Gubernija	9	2,22	0,63	2,22	0,63	2,44	0,50	2,30
Invalda	9	3,22	0,42	3,00	0,67	3,11	0,57	3,11
Kauno Energija	7	2,43	0,49	2,57	0,49	2,71	0,70	2,57
Kauno Tiekimas	5	2,40	0,80	2,00	0,89	2,20	0,75	2,20
Klaipedos Baldai	8	2,75	0,66	2,38	0,70	2,88	0,33	2,67
Klaipedos Juru Kroviniu Kompanija	5	2,80	0,40	2,60	0,49	2,67	0,47	2,69
Klaipedos Nafta	10	2,70	0,64	2,80	0,75	3,10	0,54	2,87
Lietuvos Dujos	9	3,89	0,57	3,56	0,50	3,44	0,83	3,63
Lietuvos Elektrine	8	3,13	0,33	2,67	1,05	2,88	0,60	2,89
Lietuvos Energija	9	3,22	0,42	2,89	0,57	3,00	0,82	3,04
Lietuvos Juru Laivininkyste	8	2,50	0,87	2,38	0,86	2,50	0,71	2,46
Lifosa	8	3,00	0,50	2,63	0,48	2,88	1,05	2,83
Limarko Laivininkystes Kompanija	5	3,20	0,75	3,00	0,58	2,83	0,69	3,01
Linas	7	2,29	0,45	2,29	0,70	2,29	0,70	2,29
Lisco Baltic Service	8	3,00	0,50	2,25	0,66	2,75	0,43	2,67
Mazeikiu Elektrine	7	2,71	0,70	2,86	0,64	2,71	0,70	2,76
Mazeikiu Nafta	10	3,90	0,70	3,10	0,94	3,10	0,94	3,37
Panevezio Statybos Trestas	9	2,56	0,50	2,11	0,74	2,25	0,83	2,31
Pramprojektas	5	2,40	0,80	1,71	1,28	2,17	0,69	2,09
Rytu Skirstomieji Tinklai	9	3,11	0,74	3,00	0,47	3,00	0,67	3,04
Sanitas	9	3,44	0,68	3,22	0,63	3,33	0,94	3,33
Stumbras	9	3,56	0,50	3,11	0,57	3,22	0,79	3,30
Vakaru Skirstomieji Tinklai	9	3,89	0,57	3,67	0,47	3,33	0,47	3,63
Vilniaus Degtine	6	3,17	0,37	3,00	0,58	2,83	0,69	3,00
Siauliu Bankas	9	3,22	0,63	3,33	0,67	3,11	0,57	3,22
Ukio Bankas	7	2,57	0,49	2,14	0,35	2,14	0,64	2,29
Zemaitijos Pienas	9	2,56	0,83	2,22	0,79	2,56	0,68	2,44
Average		***3,03***		***2,85***		***2,94***		***2,94***
Standard deviation		***0,54***		***0,57***		***0,47***		***0,51***

5.2 Variables

In this part I will present the variables used in the study with detailed description and calculation formulas.

5.2.1 Dependent Variables

For company valuations I use the natural logarithm of Tobin's Q (T_Q). Tobin's Q is a relative market valuation measurement, calculated by dividing the market value of the company's assets by the replacement costs of its assets. The major problem is calculating these replacement costs. To overcome this problem, previous research has used several different approximation formulas for Tobin's Q [see e.g. Chung and Pruitt (1994), Lindenberg and Ross (1981)]. I follow the same approximation as Klapper and Love (2004) and calculate Tobin's Q as:

Tobin's Q = (market value of common stock + market value of preferred stock + book value of debt) / book value of total assets *(Equation 1)*

To measure company performance I use ROA, which is theoretically better than ROE, because it is not affected by different capital structures. To calculate ROA I use audited financial data from the fiscal years 2004 and 2003. In addition I use unaudited data for SAF Tehnika at 31.12.2004, because their financial year differs from the calendar year. Average assets and average equity are defined as the arithmetic average of the year-end values at 31.12.2004 and 31.12.2003.

ROA= (net income / Average assets) *(Equation 2)*

Volatility (VOL) is calculated from the daily return using the data from the whole year 2004. To annualize the daily volatility I use 252 trading days:

$$VOL_i = \sqrt{252} * \sqrt{\sum (X_i - \mu)^2 / (N-1)} \qquad \textit{(Equation 3)}$$

where X_i equals the logarithmic daily return, μ equals the average daily return, N equals the total number trading days for the stock. The daily returns are adjusted for capital changes.

Dividend payout (DP) is a binary variable used in the logistic regression with hypothesis (7) and (8). The variable can take two values:

$$DP = \begin{cases} 0, \text{ if the company paid no dividends} \\ 1, \text{ if the company paid dividends} \end{cases}$$

Dividend payout ratio (DPR) is the ratio of the paid out dividends to company net income for the fiscal year 2004. From this variable I have excluded those dividend paying companies that paid their shareholders more than 100% of 2004 net profits on the basis that this payout ratio is not sustainable in the long run.

5.2.2 Independent Variables

The Corporate Governance index (GOV_i) is constructed as a weighted average (1/3 weight on each subindex) of the three subindices: Quality of Management and Board (QMB_i), Inverstor Rights (IR_i) and Tranparency and Disclosure (TD_i). The three subindices are formed as an arithmetic average of the survey results.

When testing the effects of ownership concentration, I use three different levels of concentration, measured by the ownership of the largest shareholder: above 40% (OC_{40}), above 50% (OC_{50}) and above 90% (OC_{90}) of shares.

5.2.3 Control Variables

I use several control variables to check for robustness of the tested variables. The idea is to test if the results are truly caused by the tested variable or due to some other factors. In my regressions I use the following control variables:

A country (CTRY) dummy is a control variable used to capture possible country specific differences.

Sales Growth (SalesG) is a control variable, which checks if strong growth influences the regression results. It is calculated as the average growth rate during 2001-2004 or for a shorter time period depending on the data availability. A growing firm with large needs for outside financing has more incentives to adopt better governance practices in order to lower its cost of capital. I use sales rather than earnings growth to avoid dealing with the volatility and manipulability of earnings. For Banks I replace the sales growth with total assets growth.

Size (Size) is a control variable to assess if the size of the company has an effect on the estimations. Size is defined as ln(total assets). The larger companies are usually the blue chip stocks of the exchanges, which makes them more interesting for both local and foreign investors and they tend to be therefore better followed by analysts. I also tried to use ln(sales) as a second proxy for size but this resulted in multicollinearity in the model as ln(sales) and ln(total assets) correlation score was 0.876. I therefore excluded ln(sales) from the final model.

Liquidity (Liq) is a control variable closely related to size. There are several large mainly state owned enterprises, which have large asset values but miniscule free float. With the liquidity control variable we can identify the real blue chip stocks of the exchanges. Liquidity is defined as the logarithm of the total EUR turnover of the stock in 2004.

Income to Sales (IS) is measured as the ratio of net income to total sales (net margin). This control variable is used to test the valuation based hypothesis, but

dropped out on performance hypothesis due to high correlation with the dependent variable.

GDR (GDR) is a dummy trying to capture the effects of a GDR listing abroad. I have only given this value to Estonian Telecom and Lithuanian Telecom. There have been other GDR listed companies as well, such as Rokiskio Suris, but the status of these programs is unclear. [13]

Bank (BANK) is a dummy variable to capture possible effects of banks and other companies. This test is done because the corporate governance requirements for banks and other financial institutions, such as insurance companies, differ from the requirements set to other industries: Financial institutions are usually closely regulated and monitored by the local financial supervision authorities and this regulatory influence might affect governance scores.

Table 10 on the following page summarizes all the variables used in the study.

[13] The Rokiskio Suris GDR dates back to 1997. The CUSIP code for the program is 77543K107, but I have been unable to find any current listing places for the program. The company itself does not mention the GDR program on its website nor on its 2004 Annual Statement, so it is possible the program has been terminated.

Table 10

List and description of variables and control variables used

The table presents all the variables used, their abbreviation and a description of their construction or calculation of formulas.

Variables	Short name	Description
Tobin's Q	T_Q	Estimated as ln [market value of common stock + market value of preferred stock + book value of long-term debt) / book value of total assets]
Return on Assets	ROA	Calculated as (Net income / Average assets)
Dividend payout	DP	Dividend payout (2004) as Binary (0/1) variable. 0 equals no dividends paid, 1 equals paid out dividends
Dividend payout Ratio	DPR	Dividend payout ratio (2004)
Volatility	VOL	The annualized daily volatility (12 months)
Governance Index	GOV_i	The overall corporate governance index score, which is constructed as the weighted average of the three sub indices.
Quality of Management and Board	QMB_i	The Quality of Management and Board subindex, which is constructed as an arithmetic average on the questionnaire assessments.
Investor Rights	IR_i	The Investor Rights subindex, which is constructed as an arithmetic average on the questionnaire assessments.
Transparency and Disclosure	TD_i	The Transparency and Disclosure subindex, which is constructed as an arithmetic average on the questionnaire assessments.
Ownership Concentration 40%	OC_{40}	The largest owner owns over 40% of shares
Ownership Concentration 50%	OC_{50}	The largest owner owns over 50% of shares
Ownership Concentration 90%	OC_{90}	The largest owner owns over 90% of shares
Country	CTRY	A country dummy for Estonia, Latvia and Lithuania
Bank	BANK	Bank dummy
Sales Growth	SalesG	A geometric average growth rate of sales during the last 3 fiscal years from 2002 to 2004 (shorter period if information not available)
Size Assets	SizeA	Ln (total assets)
Liquidity	Liq	Ln (total traded volume in 2004)
GDR	GDR	GDR dummy
Income to Sales	IS	Net Income to Total Sales

5.3 Methodology

To test my hypothesis I use a normal OLS regression and Logistic regression. I add several control variables and also test the joint explanatory power of independent variables as a robustness check of the results.

To test the basic hypotheses I use a simple OLS regression model:

$$DEP_i = \alpha + \beta_1 VAR_i + \beta_j Control_j \qquad \textit{(Equation 4)}$$

where DEP_i equals the dependent variables: Tobin's Q (T_Q), ROA (ROA_i), Dividend yield (DPR), Volatility (Vol) and Transparency and Disclosure score (TD_i). VAR_i equals the firm level independent variables (GOV_i, TD_i, OC_{40}, OC_{50}, OC_{90}). $Control_j$ refers to the control variables: *CTRY, SalesG, SizeA, Liq, Bank, GDR* and *IS*.

For Hypothesis (1), (2) and (3) the dependent variable is Tobin's Q (T_Q), the independent variables are: GOV_i, TD_i, OC_{40} and OC_{50}. The expected H0: $\beta_1 > 0$ and for hypothesis (4) with independent variable OC_{90}, H0: $\beta_1 < 0$. All control variables are in use.

For hypothesis (5) and (6) the dependent variables is ROA (ROA_i). The independent variables are GOV_i, OC_{40} and OC_{50} with the expected H0: $\beta_1 > 0$. Income to Sales (IS) control variable is left out due to multicollinearity reasons. Control variable liquidity (Liq) is left out because its presence cannot be theoretically justified: The stocks liquidity cannot explain the company's performance.

To minimize statistical problems the cash flow hypothesis (7) and (8) are tested using a two-stage test procedure. The first logistic regression is used to determine

if ownership concentration and governance score lead to dividend payments. The dependent variable is a binary variable Dividend payout (*DP*) and the independent variables OC_{40}, OC_{50}, OC_{90}, GOV_i and IR_i. The expected H0: $\beta_1 > 0$. The regression formulation is the same as in the other regressions. The second stage in testing the (7) and (8) hypothesis is an OLS regression, which is used to determine if the independent variables have an effect on the amount of dividend payments. The dependent variable is Dividend payout ratio (*DPR*) and the independent variables OC_{40} , OC_{50}, OC_{90}, GOV_i and IR_i. The expected H0: $\beta_1 > 0$. In both regressions control variables *Bank, SalesG, SizeA, CTRY* and *IS* are used.

Hypothesis (9) tests the effect of a good transparency score TD_i to stock volatility (VOL_i). The dependent variable is VOL_i and independent variables TD_i. The expected H0: $\beta_1 < 0$.

Hypothesis (10) checks if higher ownership concentration has an effect on the transparency of the company. The dependent variable is TD_i and the independent variables OC_{40}, OC_{50} and OC_{90}. The expected H0: $\beta_1 < 0$.

5.4 Issues with the data

Because of the small sample size there is a danger that the findings can be a result of statistical problems in the data. Therefore I have carefully tested the data for non-normality of variables and residuals and for possible multicollinearity of variables. In addition I have closely monitored the regression residuals for signs of heteroscedasticity. In case some of these exist, I have taken appropriate action, described more closely in the text.

5.4.1 Normality

Variables

Ordinary least squared regression assumes that at least the dependent variables are normally distributes. Only Volatility and TD_i score fulfill this assumption, while

Tobin's Q, ROA and Dividend payout ratio do not. To achieve normal distribution I have made a logarithmic transformation to Tobin's Q and removed several outliers in the data for test with ROA.

The following outliers were removed for ROA regression:
SAF Tehnika – The Company's ROA is rather high amounting to 30%. Because of its IPO during 2004, the company's capital structure might not be stable.

Dvarcioniu Keramika – The Company's ROA amounts to –18,5% due to the heavy losses accounted for 2004.

Alytaus Tekstile – The Company's ROA amounts to –14,7% due to the heavy losses accounted for 2004.

For the dividend payout ratio regression I excluded all companies which did not distribute dividends and those companies which paid out over 100% of their 2004 net profit as this ratio is not sustainable in the long term.

To test the normality assumptions I have used a 2-tailed Kolmogorov-Smirnov test. The test results for the dependent variables after the variable transformation and outlier removal are shown in Table 11.

Table 11

Normality Tests for the dependent variables

The test statistic and significance for a 2-tailed Kolmogorov-Smirnov test for all independent variables. The test statistic value and significance are reported. The null hypothesis is that the variable is normally distributed. A low significance means that the null hypothesis should be rejected while a high value means that the null hypothesis is accepted.

Variable	Test Statistic	Significance	Operation
Ln (Tobin's Q)	0,949	0,329	Logarithmic transformation
ROA	1,010	0,260	Removal of outliers
TD_i	0,667	0,766	No operations
Volatility	1,092	0,184	No operations
Dividend payout	-	-	-
Dividend payout ratio	0,564	0,908	Removal of outliers

Residuals

The normality of residuals is also checked with a 2-tailed Kolmogorov-Smirnov test. The normality test results are reported in the regression results tables in chapter 6. None of the results give strong enough evidence to reject the null hypothesis of normality after the removal of outliers and variable transformations described above.

5.4.2 Heteroscedasticity

One of the basic assumptions of the ordinary least squares regression model is that the disturbance variance is constant, or homogeneous, across observations. If this assumption is violated, the error terms are said to be heteroscedastic. If heteroscedasticity is present in the regression, the parameter regression estimates are still consistent but they are no longer efficient. This means that results such as t-statistics derived from the standard errors are likely to be misleading. After the logarithmic transformation of the variables, heteroscedasticity should not be a problem. Further checks are done in all regression by examining the graphical scatter plot of the error terms (not reported). No clear evidence of heteroscedasticity is observed.

5.4.3 Multicollinearity

In regression analysis, multicollinearity refers to a situation of collinearity, high correlation, of independent variables. The collinearity increases the standard errors of variables making coefficients confidence intervals large and their t-statistics small. This means that coefficients have to be larger in order to be statistically significant, i.e. it is harder to reject the null hypothesis. It should be noted, however, that even with high multicollinearity, the OLS estimates are still unbiased.

To check for multicollinearity the data is analyzed using Tolerance figures and Variation Inflation Factor (VIF). The tolerance figure is the proportion of the variability of the tested variable that is not explained by its linear relationship with the other variables. The VIF score shows how much the variance of the coefficient

estimate is being inflated by collinearity. The square root of the VIF tells you how much larger the standard error is, compared with what it would be if that variable were uncorrelated with the other X variables in the equation.

The indicators are defined as:

$$Tolerance_i = (1 - R^2) \quad (5)$$

$$VIF_i = (1 - R^2)^{-1} \quad (6)$$

where R^2 is the multiple correlation coefficient when the variable (i) tested is taken as the outcome predicted by the other remaining variables.

Low tolerance scores and high VIF scores of the variables indicate multicollinearity. The problem with these tests is that no theoretical critical value tables exist. Values of VIF lower than 10 or values of Tolerance larger than 0.1 are usually considered to be acceptable. (See e.g. Craney and Surles 2002, Mason and Perreault 1991).

The correlation matrix for all the variables is presented in Table 12 on the following page. Because, not surprisingly, the components of the GOV index correlate strongly with each other, they are never used in the same regression model at the same time. If the dependent or independent variables cause multicollinearity with control variables, these control variables are excluded from the model as explained in the Methodology part. This applies to such control and independent variables as Income to sales (IS) versus ROA. Additionally I have excluded variables, which do not have a strong theoretical basis to support their co-existence in the model. This includes variable pairs such as GDR listing vs. Investor Rights (IR) and Ownership concentration over 90% vs. ROA. I have also taken into account the direction of determination, which means that I have excluded Liquidity from the ROA regressions, because there is no theoretical basis that stock liquidity should increase the company's ROA. A higher ROA could explain higher liquidity, but this is something that is not tested within the study's hypothesis.

Table 12

Variable Correlation Table

Variable correlation table. T_Q refers to Tobin's Q, ROA refers to Return on Assets, QMB_i refers to Quality of Management and Board, IR_i refers to Investor Rights, GOV_i refers to overall governance index score, SalesG refers to Sales Growth, Liq refers to Stock Liquidity, SizeA refers to Size of the Assets, IS refers to Income to Sales ratio, DPR refers to Dividend payout ratio, DP refers to dividend payout (0=no payouts, 1=payouts), GDR refers to GDR listings, OC 40/50/90 refer to ownership of the largest owner (over 40%/50%/90%), Bank refers to Banks, VOL refers to stock volatility, Estonia/Latvia/Lithuania refer to country dummies. The symbols *, ** and *** denote significance at 10%, 5% and 1% levels respectively.

	T_Q	ROA	QMB_i	IR_i	TD_i	GOV_i	SalesG	Liq	SizeA	IS	DPR	DP	GDR	OC40	OC50	OC90	BANK	VOL	Estonia	Latvia	Lithuania
T_Q	-																				
ROA	0,567***	-																			
QMB_i	0,332***	0,159	-																		
IR_i	0,328***	0,088	0,940***	-																	
TD_i	0,316***	0,102	0,928***	0,953***	-																
GOV_i	0,332***	0,118	0,975***	0,985***	0,980***	-															
SalesG	-0,005	-0,001	-0,090	-0,146	-0,127	-0,124	-														
Liq	0,437***	0,451***	0,202	0,153	0,162	0,175	-0,021	-													
SizeA	-0,121	0,145	0,221*	0,119	0,138	0,161	0,021	0,384***	-												
IS	0,225*	0,762***	0,151	0,084	0,092	0,110	-0,026	0,300**	0,264**	-											
DPR	-0,216*	-0,088	0,11	0,083	0,055	0,084	-0,048	-0,005	0,171	-0,056	-										
DP	0,304**	0,315***	0,347***	0,325***	0,305**	0,332***	-0,101	0,320***	0,239*	0,254**	0,215*	-									
GDR	0,240*	0,135	0,305**	0,328***	0,378***	0,344***	-0,051	0,323***	0,222*	0,109	0,039	0,163	-								
OC40	-0,168	-0,141	0,03	0,102	0,058	0,066	-0,246**	-0,190	0,102	-0,155	0,122	-0,119	0,110	-							
OC50	-0,106	-0,108	0,07	0,074	0,082	0,077	-0,182	-0,195	0,089	-0,209*	0,196	-0,072	0,008	0,602***	-						
OC90	-0,240*	-0,082	0,168	0,114	0,148	0,145	-0,087	-0,173	0,173	-0,024	0,359***	-0,113	-0,082	0,294**	0,489***	-					
BANK	-0,090	-0,132	-0,032	-0,041	-0,013	-0,03	0,059	0,068	0,398***	-0,099	-0,049	0,107	-0,044	-0,121	-0,115	0,047	-				
VOL	-0,974***	-0,356***	-0,087	-0,021	-0,042	-0,05	0,099	-0,445***	-0,273**	-0,307**	-0,051	-0,179	-0,220*	0,105	0,052	0,131	-0,023	-			
Estonia	0,181	0,218*	0,063	0,188	0,145	0,137	-0,052	0,005	-0,210*	0,101	-0,079	-0,035	0,147	0,035	0,099	-0,015	-0,118	0,150	-		
Latvia	-0,103	0,118	-0,306**	-0,274**	-0,342***	-0,313**	-0,062	0,053	0,002	0,248**	-0,093	-0,191	-0,082	0,035	-0,369***	-0,218*	-0,118	-0,055	-0,218*	-	
Lithuania	-0,062	-0,269**	0,195	0,069	0,158	0,141	0,091	-0,046	0,166	-0,279**	0,138	0,181	-0,052	-0,056	0,216*	0,187	0,188	-0,076	-0,625***	-0,625***	-

5.5 Qualitative Study

In addition to the quantitative questions, the survey participants were asked for comments on corporate governance practices in the Baltic States (see Appendix I for questionnaire). The questionnaire's general part asked the participants what they see as the biggest governance problem and what they thought should be done about it. In addition the participants were asked to compare the practices among the countries (country differences) and the possible causes of the differences. The second major topic was minority protection and ownership structure. This included questions on the actual protection of minority rights, possible country differences as well as the legal possibility to enforce minority rights. The other questions were regarding compliance with mandatory bid rules as well as ownership concentration and state ownership of Baltic companies. The third major line of questions asked the participants their views on company transparency and what should be done to improve it.

5.6 Problems with the Methodology

The questionnaire based evaluation approach has some problems. While it has the advantage of measuring the essence, instead of the form, it creates the possibility for participant's bias. The perception of the participants is most likely based on historical data and might therefore be out-of-date or biased due to other historical events. The only way to control this problem is to increase the number of participants in the study. This way the effects of a single participants biased views to the overall results are minimized. Unfortunately, because the Baltic markets are so small, the number of participants in this study is smaller than in similar type of surveys elsewhere.

Due to different legal requirements, enforcement and business practices cross-border comparison of governance is problematic. While meaningful differences in company level governance could be found, these difference could be eliminated if

it was possible to accurately assess the effects of the country's legal framework to the company level governance.

Another problem evident in this study and many other similar studies is the sample selection bias. Because my sample only uses the listed companies of the Baltic countries, it is inherently excluding a large part of the total statistical population. Thus it especially discriminates against small companies, which have no representatives in the stock exchange trading lists. This problem could only be avoided by evaluating also non-listed companies. This approach is unfortunately very problematic due to the lack of available data. Also the larger, but financially troubled companies (e.g. some old government monopolies) are less likely to be listed, which leads to a performance bias in the sample [Börsch-Supan and Köke (2002)].

In addition, as with many other governance studies as criticized by Börsch-Supan and Köke (2002), this study has several endogeneity problems. A common example is as follows: a growing firm with large needs for outside financing has more incentives to adopt better governance practices in order to lower its cost of capital. However the market should also reflect these growth opportunities in the market valuation of the firm, thus inducing a positive correlation between corporate governance and Tobin's Q. Hypothesis (6) also suffers from structural reverse causality. The direction of causality between performance and ownership concentration is unclear: concentrated ownership can improve firm performance through better monitoring, but well performing companies also attract investor as noted by Börsch-Supan and Köke (2002).

6. Analysis and Results

In this chapter I present my findings. Part 6.1 presents the quantitative results, while 6.2 concentrates on analyzing the qualitative answers.

6.1 Quantitative Analysis

The quantitative part presents the results for the hypothesis tests. I start by showing the significant differences among the countries, followed by the company valuations hypothesis tests. Chapter 6.1.3 contains the test results for the company performance hypothesis. After this come the free cash flow hypothesis tests and transparency hypothesis tests.

6.1.1 Country Differences

As a preliminary test I checked for country specific differences in the governance index scores. **Table 13** summarizes the results. Estonia's scores are the highest so it is set as a benchmark to the other countries. Lithuania scores lower points, but the results are not statistically significant. Latvia on the other hand is clearly weaker in all governance respects with the 5% significance level. Due to these results I will provide all other test results with and without the country dummies.

Table 13

Country differences in Governance index scores

Estonia is set as the benchmark, into which the Latvian and Lithuanian scores are compared against. GOV_i refers to the overall governance index, TD_i refers to the Transparency and Disclosure index, IR_i refers to the Investor Rights index and QMB_i refers to the Management and Board Quality index. The symbols *, ** and *** denote significance at 10%, 5% and 1% levels respectively.

	Dependent variable			
Independent variable	GOV_i	TD_i	IR_i	QMB_i
Constant	3,069	3,071	3,112	3,023
	(16,081)***	(16,443)***	(14,865)***	(16,078)***
Latvia	-0,657	-0,705	-0,737	-0,529
	(-2,434)**	(-2,669)***	(-2,490)**	(-1,988)*
Lithuania	-0,128	-0,131	-0,262	0,007
	(-0,595)	(-0,619)	(-1,106)	-0,034

6.1.2 Company Valuation

The first two hypotheses predicted that better corporate governance increases the value of the company. According to the theory, firms with better corporate governance are less risky, which should lower the cost of capital (the investor required rate of return). The evidence from the Baltic States supports this. The results for the regression are shown in Table 14 on the following page.

The first regression (0) is done to check the stand-alone significance of the control variables: Out of the six independent variables Size and Liquidity are significant at the 1% level. They also remain significant in all the other regressions (I-XI). The somewhat surprising result is the negative coefficient of the Size variable. Usually in emerging markets the large companies are the blue chips of the market and they are valued higher than smaller firms. One explanation for this result is the small free float and extremely concentrated ownership in some of the largest companies such as Lietuvos Energija and Latvijas Gaze. In some cases the dominant owner may not be the best owner from the minorities perspective. Possible problems include both state ownership and otherwise problematic owners such as Yukos' 53,7% ownership in the Lithuanian refinery Mazeikiai Nafta.[14]

The positive coefficient of liquidity is somewhat straightforward. Investors logically require a higher rate of return for holding a stock with higher liquidity risk. This leads to lower market valuation. One of the main causes of poor liquidity in smaller firms and in some cases also in the large companies is the small free float. This results in sporadic trading and wider bid-ask spreads, which in turn increases the liquidity risk of the stock.

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[14] After the fall of Mr. Khodorkovsky, the sale of Mazeikiu Nafta stake held by Yukos has been a continuous process with numerous twists. The latest news in October 2005 included a freeze on the sale for 90 days by a Dutch court order.

Table 14

OLS Regression with Tobin's Q as the dependent variable

Regression of company valuation measured as Ln (Tobin's Q) and independent variables: Overall Governance Index score (GOV_i), Transparency and Disclosure index score (TD_i), Ownership concentration (largest owner owns above) 40% (OC40), 50% (OC50) and 90% (OC90) levels. Control variables include: a bank dummy (BANK) for banks, sales growth (SalesG) measured as the growth percentage of sales during 2001-2004 or for shorter time period, Size (SizeA) measured as the natural logarithm of total assets at the end of 2004, Liquidity (LIQ) measured as the natural logarithm of the total EUR trading volume of the stock during 2004, a GDR dummy (GDR) to measure the impact of the company having a global depositary receipt listing abroad, Income to Sales ratio (IS) defined as the net income divided by total sales during 2004 and country dummies for Estonia, Latvia and Lithuania. The expected signs for the independent variables are also reported. The normality of residuals is tested using the Kolmogorov-Smirnov test. A low significance score means that the residual is non-normally distributed. Multicollinearity test scores of Tolerance and Variance Inflation Factor (VIF) are also reported. VIF values lower than 10 and Tolerance values above 0,1 are usually considered acceptable. The symbols *, ** and *** denote significance at 10%, 5% and 1% levels respectively. "O" refers to a base scenario to measure the impact of the control variables, while I-XI refer to the actual regressions.

		Dependent variable Tobin's Q																					
		With country dummies											Without country dummies										
Independent Variable	Expected Sign	O	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	O	I	II	III	IV	V	VI	VII	VIII	IX	X	XI
Constant		0,879	0,549	0,499	0,879	0,900	0,784	0,524	0,566	0,392	0,472	0,509	0,331	0,878	0,519	0,456	0,876	0,946	0,817	0,516	0,579	0,385	0,455	0,518	0,312
		(1,057)	(0,669)	(0,597)	(1,047)	(1,066)	(0,938)	(0,611)	(0,658)	(0,462)	(0,540)	(0,581)	(0,382)	(1,062)	(0,648)	(0,560)	(1,051)	(1,135)	(0,978)	(0,639)	(0,715)	(0,478)	(0,553)	(0,628)	(0,380)
GOV_i	+		0,179					0,178	0,181	0,190					0,198					0,198	0,195	0,215			
			(2,188)**					(2.170)**	(2.197)**	(2.327)**					(2,630)**					(2,608)**	(2,568)**	(2,809)***			
TD_i	+			0,163							0,164	0,166	0,176			0,186							0,186	0,182	0,204
				(1,924)*							(1.907)*	(1.933)*	(2.069)*			(2,309)**							(2.372)**	(2,324)**	(2,580)**
OC_{40}	+				0,001			-0,008			-0,005						-0,012			-0,013			-0,010		
					(0,005)			(-0,064)			(-0,040)						(-0,093)			(-0,107)			(-0,079)		
OC_{50}	+					0,026			0,047			0,045						0,088			0,070			0,069	
						(0,211)			(0,399)			(0,372)						(0,789)			(0,652)			(0,635)	
OC_{90}	-						-0,153			-0,185			-0,184						-0,094			-0,160			-0,160
							(-1,074)			(-1,344)			(-1,323)						(-0,675)			(-1,197)			(-1,181)
BANK		0,103	0,143	0,124	0,103	0,119	0,081	0,140	0,173	0,119	0,121	0,151	0,099	0,135	0,161	0,140	0,129	0,182	0,125	0,155	0,198	0,146	0,135	0,176	0,123
		(0,431)	(0,617)	(0,528)	(0,418)	(0,471)	(0,339)	(0,582)	(0,704)	(0,515)	(0,501)	(0,611)	(0,423)	(0,565)	(0,706)	(0,608)	(0,524)	(0,737)	(0,519)	(0,657)	(0,838)	(0,641)	(0,569)	(0,741)	(0,536)
SalesG		0,009	0,030	0,028	0,01	0,013	0,001	0,029	0,036	0,020	0,028	0,035	0,019	0,015	0,034	0,033	0,013	0,025	0,010	0,032	0,042	0,027	0,031	0,041	0,026
		(0,140)	(0,453)	(0,427)	(0,136)	(0,185)	(0,008)	(0,418)	(0,534)	(0,309)	(0,400)	(0,502)	(0,288)	(0,216)	(0,526)	(0,504)	(0,182)	(0,370)	(0,143)	(0,475)	(0,640)	(0,422)	(0,461)	(0,614)	(0,404)
SizeA		-0,148	-0,157	-0,152	-0,148	-0,151	-0,133	-0,156	-0,163	-0,140	-0,151	-0,158	-0,135	-0,150	-0,159	-0,155	-0,148	-0,162	-0,141	-0,158	-0,168	-0,145	-0,154	-0,164	-0,140
		(-3,068)***	(-3,343)***	(-3,225)***	(-2,890)***	(-2,936)***	(-2,673)***	(-3,131)***	(-3,254)***	(-2,903)***	(-3,025)***	(-3,136)***	(-2,782)***	(-3,223)***	(-3,579)***	(-3,451)***	(-3,026)***	(-3,300)***	(-2,906)***	(-3,361)***	(-3,594)***	(3,156)***	(-3,246)***	(-3,465)***	(-3,021)***
Liq		0,131	0,128	0,129	0,131	0,133	0,123	0,128	0,131	0,118	0,129	0,132	0,119	0,130	0,128	0,129	0,129	0,136	0,125	0,127	0,132	0,118	0,128	0,134	0,120
		(4,081)***	(4,118)***	(4,119)***	(3,884)***	(3,978)***	(3,716)***	(3,899)***	(4,065)***	(3,700)***	(3,907)***	(4,058)***	(3,706)***	(4,039)***	(4,152)***	(4,154)***	(3,825)***	(4,099)***	(3,748)***	(3,929)***	(4,170)***	(3,749)***	(3,939)***	(4,168)***	(3,757)***
GDR		0,379	0,196	0,181	0,379	0,383	0,344	0,198	0,199	0,141	0,182	0,183	0,123	0,446	0,206	0,186	0,450	0,442	0,430	0,210	0,207	0,160	0,189	0,188	0,135
		(1,183)	(0,607)	(0,547)	(1,162)	(1,181)	(1,068)	(0,605)	(0,612)	(0,438)	(0,544)	(0,550)	(0,372)	(1,415)	(0,656)	(0,578)	(1,403)	(1,397)	(1,356)	(0,659)	(0,655)	(0,507)	(0,578)	(0,581)	(0,416)
IS		0,922	0,795	0,804	0,923	0,944	0,936	0,787	0,834	0,804	0,800	0,841	0,812	0,771	0,726	0,735	0,761	0,875	0,760	0,716	0,810	0,705	0,727	0,817	0,714
		1,781	(1,575)	(1,579)	(1,718)*	(1,773)*	(1,810)*	(1.502)	(1.611)	(1.603)	(1.511)	(1.609)	(1.604)	(1,563)	(1,543)	(1,547)	(1,498)	(1,708)*	(1,533)	(1,476)	(1,652)	(1,501)	(1,486)	(1,652)	(1,506)
R-squared		0,362	0,411	0,401	0,362	0,362	0,375	0,411	0,413	0,430	0,401	0,402	0,419	0,337	0,406	0,395	0,337	0,344	0,342	0,406	0,411	0,421	0,395	0,400	0,410
Adjusted R-Squared		0,274	0,318	0,306	0,261	0,262	0,276	0,306	0,308	0,328	0,294	0,296	0,315	0,270	0,336	0,324	0,258	0,266	0,264	0,325	0,329	0,341	0,312	0,317	0,328
Number of Observations		67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67
Country Dummies		YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	NO	NO	NO	NO	NO	NO	NO	NO	NO	NO	NO	NO
Residuals																									
Kolmogorov Smirnov Z		0,573	0,457	0,453	0,572	0,593	0,654	0,445	0,435	0,563	0,446	0,445	0,432	0,646	0,485	0,461	0,667	0,659	0,664	0,481	0,547	0,654	0,468	0,481	0,488
Asymp Sig (2-tailed)		0,898	0,985	0,986	0,899	0,873	0,786	0,989	0,992	0,909	0,989	0,989	0,992	0,798	0,973	0,983	0,766	0,777	0,771	0,975	0,926	0,786	0,981	0,975	0,971
Collinearity																									
Tolerance max		0,988	0,968	0,966	0,922	0,932	0,973	0,907	0,910	0,957	0,904	0,908	0,955	0,994	0,981	0,980	0,923	0,953	0,983	0,912	0,944	0,973	0,911	0,944	0,973
Tolerance min		0,530	0,522	0,516	0,523	0,495	0,530	0,545	0,532	0,562	0,547	0,536	0,564	0,655	0,650	0,653	0,598	0,594	0,607	0,594	0,592	0,606	0,596	0,594	0,607
VIF max		1,888	1,917	1,938	1,910	2,019	1,888	1,835	1,880	1,779	1,828	1,867	1,774	1,528	1,538	1,531	1,673	1,683	1,648	1,683	1,688	1,650	1,677	1,683	1,648
VIF min		1,013	1,033	1,035	1,085	1,072	1,028	1,103	1,099	1,045	1,106	1,102	1,047	1,006	1,020	1,020	1,083	1,049	1,018	1,096	1,060	1,027	1,097	1,060	1,028

Another surprising finding is the lack of significance of the Income to Sales ratio, which is significant only at the 10% level in regressions (III), (IV) and (V) and in regression (IV) without country dummies.

The (I) regression tests the effects of the governance index to the firms' valuation. The Gov_i coefficient value is positive and significant at the 5% level. I can therefore accept the first hypothesis that a higher governance score leads to higher valuations. However the second regression (II), which tests the effects of the disclosure and transparency (TD_i) subindex to Tobin's Q, is only significant at the 10% level. When I drop out the country dummies the TD_i becomes significant at the 5% level, but is still behind the overall governance index. Based on this evidence I therefore conclude that while governance effects firm valuations positively, good transparency and disclosure on a stand-alone basis seems to be a weaker factor in improving the firm's value.

Hypothesis (3) predicts that concentrated ownership, an ultimate owner, increases company value. The hypothesis is estimated by using two ownership levels: 40% (III) and 50% (IV). The 50% is the mandatory bid level in Estonia and Latvia, while 40% applies to Lithuania. Contradictory to the theory the large holdings of an ultimate owner does not seem to have any statistical significance. One reason for this result might be the fact that most Baltic companies have an ultimate owner of this size and therefore the small sample size of companies with smaller ownership concentration is too small.

The last valuation based hypothesis states that very high ownership ratios, in which the largest shareholder owns over 90% will negatively affect company value. Although the results from the regression (V) are not statistically significant, the coefficient is negative, implying that the hypothesis should not be totally abandoned.

To further check for robustness of these results I made joint regressions (VI-XI) using several independent variables. The joint hypothesis results are mostly in line with the basic regressions with the exception of the significance of the TD_i when jointly regressed with ownership concentration variables. With the country dummies in place the TD_i score dropped back down to only 10% significance. This check further shows the weaker link between good transparency and disclosure on a stand-alone basis in improving the firm's value when compared to the overall governance index.

6.1.3 Company Performance

Previous research by Klapper and Love (2004) predicts that companies with better corporate governance are also on average more profitable (hypothesis 5). My findings in the Baltic companies do not support this. This result is inline with Black, Jang and Kim (2005). Table 15 shows the results for the performance regression.

The (0) regression tests the significance of the control variables. As with the company valuation regression, Size has also a large significance in explaining ROA. This can be partly explained with the data: Several of the largest Baltic companies made very good results in 2004, including e.g. Mazeikiu Nafta, which benefited from the rising oil prices. Some of the smallest firms e.g. Dvarcioniu Keramika, on the other hand, recorded heavy losses for 2004. In addition to the size variable, also the Bank dummy coefficient is significant, but somewhat surprisingly negative. This is a surprise given the generally higher profitability of emerging market banks, which benefit from higher lending margins and stronger growth compared to their Western counterparts.

Table 15

OLS Regression with ROA as the dependent variable

Regression of company performance (measured with ROA) and independent variables: Overall Governance Index score (GOV_i), Ownership concentration (largest owner owns above) 40% (OC40) and 50% (OC50) levels. Control variables include: a bank dummy (BANK) for banks, sales growth (SalesG) measured as the growth percentage of sales during 2001-2004 or for shorter time period, Size (SizeA) measured as the natural logarithm of total assets at the end of 2004, a GDR dummy (GDR) to measure the impact of the company having a global depositary receipt listing abroad and country dummies for Estonia, Latvia and Lithuania. The expected signs for the independent variables are also reported. The normality of residuals is tested using the Kolmogorov-Smirnov test. A low significance score means that the residual is non-normally distributed. Multicollinearity test scores of Tolerance and Variance Inflation Factor (VIF) are also reported. VIF values lower than 10 and Tolerance values above 0,1 are usually considered acceptable. The symbols *, ** and *** denote significance at 10%, 5% and 1% levels respectively. "O" refers to a base scenario to measure the impact of the control variables, while I-V refer to the actual regressions.

		Dependent variable ROA											
		With country dummies						Without country dummies					
Independent Variable	Expected Sign	O	I	II	III	IV	V	O	I	II	III	IV	V
Constant		-0,239	-0,265	-0,242	-0,254	-0,266	-0,276	-0,206	-0,238	-0,208	-0,211	-0,239	-0,244
		(-1,809)*	(-1,953)*	(-1,825)*	(-1,891)*	(-1,961)*	(-2,010)	(-1,525)	(-1,714)*	(-1,539)	(-1,544)	(-1,716)*	(-1,737)*
GOV_i	+		0,013			0,013	0,012		0,014			0,014	0,015
			(0,889)			(0,858)	(0,818)		(1,001)			(0,955)	
OC_{40}	+			-0,020		-0,020				-0,019		-0,018	
				(-1,001)		(-0,972)				(-0,903)		(-0,855)	
OC_{50}	+				-0,015		-0,013				-0,007		-0,008
					(-0,751)		(-0,668)				(-0,387)		(-0,428)
BANK		-0,082	-0,078	-0,087	-0,089	-0,084	-0,085	-0,082	-0,080	-0,088	-0,085	-0,086	-0,083
		(-2,029)**	(-1,928)*	(-2,152)**	(-2,142)**	(-2,049)*	(-2,025)*	(-2,019)**	(-1,968)*	(-2,133)**	(-2,040)**	(-2,074)**	(-1,997)*
SalesG		-0,001	0,000	-0,004	-0,003	-0,002	-0,001	-0,003	-0,001	-0,005	-0,003	-0,004	-0,002
		(-0,107)	(0,027)	(-0,335)	(-0,264)	(-0,199)	(-0,123)	(-0,217)	(-0,090)	(-0,425)	(-0,278)	(-0,294)	(-0,158)
SizeA		0,019	0,018	0,020	0,021	0,019	0,020	0,015	0,014	0,016	0,015	0,015	0,015
		(2,521)**	(2,403)**	(2,631)**	(2,617)**	(2,511)**	(2,482)**	(1,965)*	(1,891)*	(2,065)**	(1,987)*	(1,986)*	(1,922)*
GDR		0,010	-0,004	0,013	0,006	0,000	-0,007	0,034	0,017	0,037	0,033	0,020	0,015
		(0,192)	(-0,074)	(0,252)	(0,107)	(-0,008)	(-0,126)	(0,644)	(0,293)	(0,697)	(0,622)	(0,354	-0,267
R-squared		0,186	0,198	0,200	0,194	0,211	0,204	0,110	0,125	0,122	0,112	0,136	0,128
Adjusted R-Squared		0,101	0,097	0,101	0,094	0,096	0,088	0,050	0,050	0,047	0,036	0,045	0,036
Number of Observations		64	64	64	64	64	64	64	64	64	64	64	64
Country Dummies		YES	YES	YES	YES	YES	YES	NO	NO	NO	NO	NO	NO
Residuals													
Kolmogorov Smirnov Z		0,716	0,716	1,039	0,903	0,866	0,887	0,746	0,901	0,780	0,722	0,904	0,935
Asymp Sig (2-tailed)		0,685	0,685	0,230	0,388	0,442	0,411	0,635	0,392	0,577	0,675	0,387	0,346
Collinearity													
Tolerance max		0,985	0,963	0,933	0,941	0,911	0,915	0,994	0,979	0,938	0,966	0,922	0,952
Tolerance min		0,571	0,547	0,570	0,508	0,546	0,471	0,787	0,783	0,773	0,766	0,768	0,763
VIF max		1,714	1,830	1,754	1,970	1,830	2,122	1,271	1,277	1,294	1,305	1,301	1,310
VIF min		1,015	1,038	1,072	1,063	1,097	1,093	1,006	1,022	1,066	1,036	1,085	1,050

The actual (I) regression with the Governance index variable (GOV_i) provides insignificant results. The independent variable is positive, but contrary to previous research far from being significant. Even the exclusion of country dummies and the joint regression with the ownership variables does not change the results. The results for hypothesis (6) are also presented in the table. As with hypothesis (3), theory and previous research suggest that a majority owner should have a positive influence on the company's efficiency, i.e. profitability, but again my tests fail to capture any significance of a majority owner owning over 40% (II) or 50% (III). In fact the coefficients are slightly negative suggesting that a majority owner might have the opposite effect on profitability than suggested by the theory. Further test on joint explanatory power of the variables does not shed light on the issue. A possible reason for these results might again be the small number of companies in the sample or misjudgments and subjective views of the participant.

The adjusted R-square figures are relatively low in all performance regressions. This implies that the explanatory variables in this model are not very good in predicting company performance. In addition the Kolmogorov-Smirnov score becomes somewhat high in some regressions meaning that there is a elevated risk of the data suffering from non-normality problems.

6.1.4 Free Cash Flow Hypothesis and Dividend Policy

The following tests are done to check the validity of Jensen and Meckling (1976) theory in the Baltic markets. Jensen and Meckling predict that higher cash flow ownership by an entrepreneur reduces incentives for expropriation and raises incentives to pay out dividends. To minimize statistical problems I use a two-stage test procedure, where the first logistic regression is used to determine if ownership concentration and governance score lead to dividend payments and the second OLS regression to determine if the independent variables have an effect on the level of dividend payments.

The evidence from the logistic regression does not support the theory of Jensen and Meckling. Table 16 on the following page presents the results.

The (0) regression tests the significance of the control variables: The only significant variable explaining dividend payout is, as expected, income to sales ratio. However, when country dummies are excluded, the variable's significance is reduced below the 10% level. Although not statistically significant, the coefficient of Sales growth (SalesG) is negative as expected. Companies with higher financing needs due to higher growth tend to distribute dividends less often. The Bank and Size (SizeA) coefficients are positive but not significant.

Table 16

Logistic regression with dividend payout as the dependent variable

Logistic Regression of dividend payout measured with a binary dummy (0/1), where 1 refers to a company paying dividends and 0 for companies that do not pay dividends. The independent variables are: Governance Index score (GOV_i), Investor Rights (IR_i), Ownership concentration (largest owner owns above) 40% (OC40), 50% (OC50) and 90% (OC90) levels. Control variables include: a bank dummy (BANK) for banks, sales growth (SalesG) measured as the growth percentage of sales during 2001-2004 or for shorter time period, Size (SizeA) measured as the natural logarithm of total assets at the end of 2004, Income to Sales ratio (IS) defined as the net income divided by total sales during 2004 and country dummies for Estonia, Latvia and Lithuania. The expected signs for the independent variables are also reported. Wald score is presented in parenthesis. The Cox & Snell R-Square and Nagelkerke R-Square are pseudo R-Square statistics and provide an indication of the amount of variation in the dependent variable explained by the model. The symbols *, ** and *** denote significance at 10%, 5% and 1% levels respectively. "O" refers to a base scenario to measure the impact of the control variables, while I-XI refer to the actual regressions.

		Dependent variable Dividend payout [0/1]																							
		With country dummies												Without country dummies											
Independent Variable	Expected Sign	O	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	O	I	II	III	IV	V	VI	VII	VIII	IX	X	XI
Constant		-3,765	-4,238	-4,704	-5,366	-5,066	-5,149	-5,564	-5,890	-6,881	-5,726	-6,013	-6,843	-4.507	-5,067	-4,882	-5,626	-6,106	-6,287	-6,588	-6,681	-7,866	-6,823	-6,881	-7,923
		(0.847)	(1.050)	(1.257)	(1.477)	(1.358)	(1.382)	(1,638)	(1,794)	(2,207)	(1,709)	(1,842)	(2,179)	(1.278)	(1,570)	(1,441)	(1,783)	(1,981)	(2,051)	(2,326)	(2,292)	(2,930)*	(2,441)	(2,374)	(2,944)*
OC_{40}	+		-0.600					-0,672			-0,737				-0,703					-0,735			-0,799		
			(0.797)					(0,966)			(1,132)				(1,205)					(1,232)			(1,435)		
OC_{50}	+			-0.878					-0,809			-0,824				-0,287					-0,398			-0,403	
				(1.843)					(1,501)			(1,539)				(0,266)					(0,460)			(0,470)	
OC_{90}	+				-1,384					-1,495			-1,464				-0,924					-1,218			-1,166
					(3.357)*					(3,868)**			(3,755)*				(1,693)					(2,741)*			(2,545)
GOV_i	+					0,816		0,848	0,785	0,912								0,991		1,010	1,019	1,128			
						(3.249)*		(3,381)*	(2,902)*	(3,744)*								(5,409)**		(5,419)**	(5,525)**	(6,268)**			
IR_i	+						0,802				0,850	0,782	0,871						0,920				0,954	0,948	1,027
							(3.767)*				(4,044)**	(3,459)*	(4,140)**						(5,525)**				(5,719)**	(5,637)**	(6,208)**
BANK		0,573	0,317	0,107	0,422	0,847	0,844	0,586	0,382	0,658	0,574	0,375	0,661	0.766	0,458	0,621	0,688	1,017	0,993	0,720	0,801	0,875	0,689	0,774	0,864
		(0.183)	(0.053)	(0.006)	(0.092)	(0.381)	(0.376)	(0,172)	(0,072)	(0,219)	(0,165)	(0,069)	(0,219)	(0.336)	(0,113)	(0,210)	(0,262)	(0,554)	(0,526)	(0,264)	(0,327)	(0,401)	(0,240)	(0,304)	(0,389)
SalesG		-0,459	-0,566	-0,624	-0,580	-0,361	-0,330	-0,476	-0,519	-0,494	-0,450	-0,483	-0,457	-0.408	-0,537	-0,463	-0,487	-0,300	-0,270	-0,428	-0,371	-0,399	-0,403	-0,339	-0,362
		(0.566)	(0.726)	(0.723)	(0.666)	(0.341)	(0.308)	(0,497)	(0,494)	(0,437)	(0,482)	(0,475)	(0,419)	(0.449)	(0,642)	(0,496)	(0,507)	(0,235)	(0,204)	(0,400)	(0,298)	(0,298)	(0,382)	(0,270)	(0,271)
SizeA		0,190	0,248	0,280	0,296	0,123	0,127	0,179	0,208	0,229	0,188	0,213	0,231	0,247	0,311	0,278	0,321	0,177	0,201	0,234	0,218	0,269	0,262	0,244	0,291
		(0.646)	(1.014)	(1.267)	(1.342)	(0.241)	(0.256)	(0,489)	(0,644)	(0,747)	(0,535)	(0,672)	(0,753)	(1.195)	(1,745)	(1,401)	(1,777)	(0,533)	(0,682)	(0,906)	(0,770)	(1,134)	(1,129)	(0,951)	(1,317)
IS		7,056	6,413	6,385	7,039	6,716	6,897	6,005	6,260	6,748	6,133	6,446	6,956	5.102	4,495	4,785	4,944	5,019	5,105	4,301	4,592	4,792	4,341	4,689	4,91
		(4.481)**	(3.508)*	(3.412)*	(4.327)**	(3.892)**	(4.083)**	(2,947)*	(3,153)*	(3,781)*	(3,060)*	(3,315)*	(4,018)**	(2.675)	(1,964)	(2,228)	(2,451)	(2,488)	(2,573)	(1,714)	(1,963)	(2,196)	(1,741)	(2,049)	(2,319)
Cox & Snell R-Square		0.181	0,191	0,204	0,223	0,222	0,229	0,234	0,240	0,268	0,243	0,247	0,274	0.114	0,131	0,118	0,137	0,189	0,190	0,204	0,194	0,223	0,208	0,196	0,222
Nagelkerke R-Square		0.242	0,255	0,273	0,298	0,297	0,306	0,312	0,321	0,358	0,324	0,330	0,365	0.153	0,174	0,157	0,183	0,252	0,254	0,272	0,259	0,297	0,278	0,262	0,296
Number of Observations		67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67
Country Dummies		YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	NO	NO	NO	NO	NO	NO	NO	NO	NO	NO	NO	NO

The ownership concentration regressions (I), (II) and (III) produce evidence contrary to the Jensen and Meckling theory. The coefficients for 40% (OC40) and 50% (OC50) ownership are not significant but they are negative indicating that higher ownership concentration actually decreases the probability of dividend payments. The coefficient for above 90% (OC90) holdings is negative and significant at the 10% level, when country dummies are included. If the country dummies are excluded, the significance of the variables is reduced somewhat. The Cox & Snell and Nagelkerke pseudo R-figures are also considerably lower when country dummies are excluded indicating that there are large country specific differences in dividend payouts.

Regressions (IV) and (V) test the effects of good corporate governance (GOV_i) on dividend payouts inline with the work from Mitton (2004). In addition, I use investor rights (IR_i) as a stand-alone variable to check for robustness of the results.

The evidence from the Baltic markets support Mitton's results as the governance (GOV_i) coefficient is positive and statistically significant at the 10% level with country dummies and at the 5% level if country dummies are excluded. To further check for robustness of the results I made several joint regressions. The results are mostly inline with the previous regressions and in contradiction to Jensen and Meckling basic theory. Although no significant changes are evident, the joint regressions still increase the negative scores of the ownership variables and the positive governance and investor rights coefficients. This takes place with and without the country dummies. It would appear that better governed companies with higher Governance and investor rights index scores pay dividends, but in those companies were these scores are lower, the dominant owners might use other ways to compensate themselves, thus explaining the higher negative ownership coefficient scores. The problem seems to become even more serious with higher cash flow ownership e.g. over 90%.

The significance of the governance and investor rights explanatory variables is further increased when country dummies are excluded, while meantime the ownership coefficients become less significant. However, as with previous regressions, the exclusion of the country dummies decreases the models explanatory power considerably. This implies that again the Baltic countries have significant differences in this field.

The second stage of testing the hypothesis includes an ordinary least squares regression on the amount of dividends the companies distribute. Due to data problems the sample only includes those companies, which pay dividends. Table 17 presents the results from the regression.

The (0) regression tests the significance of the control variables, but no statistically significant results are found. The negative coefficient of Bank can be attributed to the very small sample size. The negative income to sales ratio (IS) implies that more profitable companies do not pay dividends in equal proportion to their sales. The adjusted R-Square figures are negative in all regressions, which means that the regression is not good in explaining the dividend payout ratio. This can be attributed to the small sample, which cannot cope with the current number of explanatory variables i.e. there are not enough statistical degrees of freedom.

Table 17

OLS regression with dividend payout as the dependent variable

OLS Regression of dividend payout ratio for those companies that pay dividends. The independent variables are: Governance Index score (GOVi), Investor Rights (IRi), Ownership concentration (largest owner owns above) 40% (OC40), 50% (OC50) and 90% (OC90) levels. Control variables include: a bank dummy (BANK) for banks, sales growth (SalesG) measured as the growth percentage of sales during 2001-2004 or for shorter time period, Size (SizeA) measured as the natural logarithm of total assets at the end of 2004, Income to Sales ratio (IS) defined as the net income divided by total sales during 2004 and net earning and country dummies for Estonia, Latvia and Lithuania. The expected signs for the independent variables are also reported. The normality of residuals is tested using the Kolmogorov-Smirnov test. A low significance score means that the residual is non-normally distributed. Multicollinearity test scores of Tolerance and Variance Inflation Factor (VIF) are also reported. VIF values lower than 10 and Tolerance values above 0,1 are usually considered acceptable. The symbols *, ** and *** denote significance at 10%, 5% and 1% levels respectively. "O" refers to a base scenario to measure the impact of the control variables, while I-XI refer to the actual regressions.

		Dependent variable Dividend payout ratio																						
		With country dummies											Without country dummies											
Independent Variable	Expected Sign	O	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	O	I	II	III	IV	V	VI	VII	VIII	IX	X	XI
Constant		-0,098	-0.008	-0,035	-0,398	-0.107	-0,160	-0,020	-0,044	-0,407	-0,071	-0,096	-0,452	0,014	0,103	0,011	-0,374	0,006	-0,051	0,093	0,007	-0,380	0,038	-0,041	0,419
		(-0.131)	(-0.010)	(-0.045)	(-0.491)	(-0.140)	(-0.209)	(-0,025)	(-0,055)	(-0,489)	(-0,091)	(-0,119)	(-0,542)	(0.019)	(0,142)	(0,015)	(-0,480)	(0,008)	(-0,070)	(0,126)	(0,009)	(-0,476)	(0,051)	(-0,053)	(-0,525)
OC_{40}	+		0.068					0,069			0,069				0,073					0,075			0,074		
			(0.788)					(0,781)			(0,786)				(0,878)					(0,870)			(0,874)		
OC_{50}	+			0,034					0,035			0,036				-0,001					0,000			0,005	
				(0,339)					(0,341)			(0,350)				(-0,013)					(0,005)			(0,053)	
OC_{90}	+				-0,184					-0,184			-0,181				-0,217						-0,216			-0,211
					(-0.946)					(-0,924)			(-0,914)				(-1,202)						(-1,173)			(-1,145)
GOV_i	+					0,011		0,016	0,013	0,011								0,011		0,015	0,011	0,009			
						(0.129)		(0,183)	(0,150)	(0,132)								(0,138)		(0,195)	(0,135)	(0,116)			
IR_i	+						0,037				0,038	0,038	0,035						0,039				0,040	0,039	0,033
							(0,491)				(0,506)	(0,492)	(0,461)						(0,558)				(0,571)	(0,549)	(0,482)
BANK		-0,196	-0,167	-0,174	-0,227	-0,188	-0,177	-0,155	-0,164	-0,219	-0,147	-0,153	-0,208	-0,182	-0,151	-0,183	-0,222	-0,174	-0,162	-0,140	-0,174	-0,216	-0,130	-0,158	-0,204
		(-1.008)	(-0.836)	(-0.833)	(-1.147)	(-0.908)	(-0.879)	(-0,727)	(-0,734)	(-1,038)	(-0,708)	(-0,708)	(-1,015)	(-0.961)	(-0,782)	(-0,899)	(-1,167)	(-0,865)	(-0,828)	(-0,678)	(-0,797)	(-1,064)	(-0,653)	(-0,749)	(-1,033)
SalesG		0,024	0,052	0,045	-0,112	0,004	-0,038	0,024	0,022	-0,132	-0,012	-0,017	-0,168	-0,098	-0,059	-0,098	-0,212	-0,114	-0,144	-0,082	-0,114	-0,225	-0,106	-0,145	-0,249
		(0,066)	(0,144)	(0,122)	(-0,291)	(0,009)	(-0,100)	(0,060)	(0,054)	(-0,312)	(-0,031)	(-0,044)	(-0,410)	(-0,311)	(-0,186)	(-0,304)	(-0,651)	(-0,333)	(-0,436)	(-0,236)	(-0,326)	(-0,640)	(-0,318)	(-0,429)	(-0,731)
SizeA		0,026	0,019	0,021	0,046	0,026	0,026	0,017	0,020	0,045	0,018	0,021	0,045	0,022	0,013	0,022	0,045	0,020	0,020	0,012	0,020	0,044	0,011	0,019	0,043
		(0,612)	(0,418)	(0,458)	(0,958)	(0,578)	(0,592)	(0,379)	(0,421)	(0,915)	(0,398)	(0,435)	(0,926)	-0,532	(0,323)	(0,500)	(1,013)	(0,483)	(0,476)	(0,269)	(0,445)	(0,952)	(0,269)	(0,425)	(0,940)
IS		-0,434	-0,386	-0,394	-0,536	-0,473	-0,595	-0,442	-0,439	-0,576	-0,552	-0,556	-0,686	-0,458	-0,405	-0,459	-0,550	-0,483	-0,575	-0,440	-0,483	-0,570	-0,524	-0,574	-0,647
		(-0,561)	(-0,493)	(-0,493)	(-0,685)	(-0,558)	(-0,697)	(-0,515)	(-0,503)	(-0,672)	(-0,640)	(-0,633)	(-0,796)	(-0,658)	(-0,577)	(-0,644)	(-0,792)	(-0,659)	(-0,780)	(-0,595)	(-0,644)	(-0,780)	(-0,706)	(-0,762)	(-0,882)
R-squared		0,105	0,131	0,110	0,142	0,106	0,115	0,132	0,111	0,142	0,142	0,121	0,151	0,069	0,099	0,069	0,124	0,070	0,081	0,101	0,070	0,125	0,112	0,082	0,133
Adjusted R-Squared		-0,139	-0,159	-0,187	-0,144	-0,192	-0,180	-0,215	-0,245	-0,201	-0,201	-0,231	-0,189	-0,086	-0,097	-0,133	-0,066	-0,132	-0,118	-0,145	-0,184	-0,114	-0,130	-0,169	-0,103
Number of Observations		29	29	29	29	29	29	29	29	29	29	29	29	29	29	29	29	29	29	29	29	29	29	29	29
Country Dummies		YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	NO	NO	NO	NO	NO	NO	NO	NO	NO	NO	NO	NO
Residuals																									
Kolmogorov Smirnov Z		0,441	0,693	0,481	0,537	0,502	0,600	0,647	0,522	0,526	0,564	0,595	0,547	0,554	0,603	0,557	0,561	0,623	0,594	0,502	0,622	0,569	0,458	0,614	0,463
Asymp Sig (2-tailed)		0,990	0,723	0,975	0,935	0,963	0,864	0,796	0,948	0,944	0,908	0,871	0,926	0,919	0,860	0,916	0,911	0,832	0,872	0,963	0,833	0,902	0,985	0,846	0,983
Collinearity tests																									
Tolerance max		0,631	0,889	0,711	0,654	0,665	0,718	0,885	0,707	0,665	0,889	0,718	0,718	0,744	0,894	0,848	0,735	0,743	0,799	0,890	0,834	0,743	0,894	0,836	0,795
Tolerance min		0,424	0,424	0,363	0,404	0,396	0,389	0,397	0,345	0,377	0,388	0,339	0,373	0,453	0,438	0,410	0,439	0,418	0,438	0,403	0,372	0,405	0,423	0,392	0,423
VIF max		2,356	2,361	2,756	2,477	2,528	2,572	2,518	2,894	2,651	2,578	2,952	2,684	2,208	2,282	2,438	2,279	2,393	2,285	2,484	2,685	2,469	2,361	2,552	2,367
VIF min		1,585	1,124	1,407	1,530	1,504	1,392	1,130	1,414	1,504	1,125	1,393	1,393	1,344	1,118	1,180	1,360	1,345	1,252	1,123	1,200	1,346	1,119	1,197	1,258

The actual hypothesis regressions (I), (II) and (III) follow a similar pattern as the logistic regressions (I), (II) and (III) in Table 16: Although ownership concentration at 40% level has a positive coefficient, the higher concentration figures of 50% and 90% become smaller and eventually negative. This implies that companies, which have a strong dominant owner, pay fewer dividends and use other means to compensate themselves. The regressions (IV) and (V) test the effect of governance and investor rights score to the level of dividends. Again the coefficients are positive, but not statistically significant.

As with previous regressions, I have made joint regressions to check for robustness of the results. The results stay inline with the hypothesis test regressions. In addition the exclusion of the country dummies does not change the results. The conclusion is that while there are some interesting coefficients e.g with the 90% ownership variable, the results are not significant. One should also be very careful in interpreting the results, as the sample size is very small.

6.1.5 Transparency and Disclosure

Based on previous research, I expect that better transparency is associated with lower volatility, because the market can value the shares based on facts not rumors. Table 18 shows the results of the regression analysis.

As usual the (0) regression is done to establish the significance of the control variables. Not surprisingly, liquidity is a significant factor affecting volatility. With poor liquidity the bid-ask spread often grows so wide that it has a large impact on the price of a stock. Keeping in mind that there are many stocks in the Baltics that have only a few trades per day or even less, this means that the combined effect of the large spread and the bid-ask bounce effect can be seen as a major cause for daily closing price volatility. Another somewhat significant control variable is income to sales ratio (IS).

Table 18

OLS Regression with Volatility as the dependent variable

Regression of stock volatility (daily 12 month volatility annualized) and independent variables: Transparency and Disclosure index score (TD_i). Control variables include: a bank dummy (BANK) for banks, sales growth (SalesG) measured as the growth percentage of sales during 2001-2004 or for shorter time period, Size (SizeA) measured as the natural logarithm of total assets at the end of 2004, Liquidity (LIQ) measured as the natural logarithm of the total EUR trading volume of the stock during 2004, a GDR dummy (GDR) to measure the impact of the company having a global depositary receipt listing abroad, Income to Sales ratio (IS) defined as the net income divided by total sales during 2004 and country dummies for Estonia, Latvia and Lithuania. The expected sign for the independent variable is also reported. The normality of residuals is tested using the Kolmogorov-Smirnov test. A low significance score means that the residual is non-normally distributed. Multicollinearity test scores of Tolerance and Variance Inflation Factor (VIF) are also reported. VIF values lower than 10 and Tolerance values above 0,1 are usually considered acceptable. The symbols *, ** and *** denote significance at 10%, 5% and 1% levels respectively. "O" refers to a base scenario to measure the impact of the control variables, while (I) refers to the actual regression.

		Dependent variable Volatility			
		With country dummy		Without country dummy	
Independent Variable	Expected Sign	O	I	O	I
Constant		0.787	0,809	0,917	0,873
		(2.919)***	(3,011)***	(3,531)***	(3,272)***
TD_i	-		0,023		0,019
			(0,825)		(0,752)
BANK		0,005	0,008	0,006	0,007
		(0,073)	(0,110)	(0,080)	(0,086)
SalesG		0,018	0,021	0,016	0,018
		(0,854)	(0,965)	(0,762)	(0,842)
SizeA		-0,003	-0,003	-0,009	-0,010
		(-0,177)	(-0,215)	(-0,642)	(-0,673)
Liq		-0,027	-0,027	-0,026	-0,027
		(-2,661)***	(-2,675)***	(-2,617)**	(-2,620)**
GDR		-0,083	-0,110	-0,056	-0,083
		(-0,823)	(-1,038)	(-0,568)	(-0,786)
IS		-0,278	-0,294	-0,218	-0,222
		(-1,717)*	(-1,799)*	(-1,407)	(-1,425)
R-squared		0,284	0,292	0,250	0,257
Adjusted R-Squared		0,185	0,180	0,175	0,169
Number of Observations		67	67	67	67
Country Dummies		YES	YES	NO	NO
Residuals					
Kolmogorov Smirnov Z		0,908	0,816	0,891	0,841
Asymp Sig (2-tailed)		0,382	0,518	0,405	0,480
Collinearity					
Tolerance max		0,988	0,966	0,994	0,980
Tolerance min		0,607	0,516	0,655	0,653
VIF max		1,647	1,938	1,528	1,531
VIF min		1,013	1,035	1,006	1,020

Companies with higher profitability seem to be less volatile, although the exclusion of the country dummies reduces the significance of this variable.

The actual regression with the transparency and disclosure index provide insignificant results. Contrary to the theory, the coefficient was actually positive. The results were also checked by using the overall corporate governance index (GOV), but the results were similar (not reported in Table 18).

It seems that stock liquidity is by far the strongest element influencing volatility at the moment. In the future, if the market gets more active better transparency might become a more important factor affecting the markets' price discovery process.

My second hypothesis concerning transparency and disclosure is based on previous studies (see e.g. Berglöf and Pajuste 2005), who have found that higher ownership concentration is linked to lower transparency. This is based on the theory that dominant shareholders receive the information they needs though other than public channels leaving less need for public disclosure. The hypothesis was tested with the 40%, 50% and 90% ownership levels. Table 19 presents the regression results.

The (0) regression tests the significance of the control variables. Only the GDR dummy is significant at the 5% level. This is somewhat expected as a GDR listing requires a more Western level of disclosure practices from the company. In addition only large companies list tend to have a GDR listing due to its extra costs. The actual regression with ownership concentration variables OC40, OC50 and OC90 all provide only insignificant evidence with and without the country dummies. Somewhat contrary to the theory,

companies that have an over 90% majority owner have a positive regression coefficient. This means that the companies actually disclose more than firm with a more diversified ownership.

Table 19

OLS Regression with Transparency and Disclosure score as the dependent variable

Regression of Transparency and Disclosure index (TD_i) score and independent variables: Ownership concentration (largest owner owns above) 40% (OC40), 50% (OC50) and 90% (OC90) levels. Control variables include: a bank dummy (BANK) for banks, sales growth (SalesG) measured as the growth percentage of sales during 2001-2004 or for shorter time period, Size (SizeA) measured as the natural logarithm of total assets at the end of 2004, Liquidity (LIQ) measured as the natural logarithm of the total EUR trading volume of the stock during 2004, a GDR dummy (GDR) to measure the impact of the company having a global depositary receipt listing abroad, Income to Sales ratio (IS) defined as the net income divided by total sales during 2004 and country dummies for Estonia, Latvia and Lithuania. The expected signs for the independent variables are also reported. The normality of residuals is tested using the Kolmogorov-Smirnov test. A low significance score means that the residual is non-normally distributed. Multicollinearity test scores of Tolerance and Variance Inflation Factor (VIF) are also reported. VIF values lower than 10 and Tolerance values above 0,1 are usually considered acceptable. The symbols *, ** and *** denote significance at 10%, 5% and 1% levels respectively. "O" refers to a base scenario to measure the impact of the control variables, while I-III refers to the actual regressions.

		Dependent variable Transparency and Disclosure score							
		With country dummies				Without country dummies			
Independent Variable	Expected Sign	O	I	II	III	O	I	II	III
Constant		2,325	2,334	2,233	2,436	2,268	2,266	2,351	2,479
		(1,851)*	(1,841)*	(1,756)*	(1,923)*	(1,716)*	(1,699)*	(1,759)*	(1,882)*
OC_{40}	-		0,034				-0,012		
			(0,176)				(-0,058)		
OC_{50}	-			-0,113				0,107	
				(-0,616)				(0,598)	
OC_{90}	-				0,178				0,324
					(0,828)				(1,477)
BANK		-0,125	-0,110	-0,194	-0,099	-0,027	-0,032	0,030	0,008
		(-0,345)	(-0,294)	(-0,510)	(-0,273)	(-0,071)	(-0,081)	(0,076)	(0,021)
SalesG		-0,116	-0,111	-0,131	-0,105	-0,098	-0,100	-0,085	-0,082
		(-1,142)	(-1,049)	(-1,249)	(-1,029)	(-0,915)	(-0,100)	(-0,771)	(-0,764)
SizeA		0,026	0,022	0,042	0,009	0,026	0,027	0,012	-0,005
		(0,357)	(0,281)	(0,542)	(0,122)	(0,347)	(0,346)	(0,148)	(-0,062)
Liq		0,010	0,013	0,003	0,020	0,007	0,006	0,014	0,025
		(0,212)	(0,251)	(0,056)	(0,401)	(0,128)	(0,106)	(0,262)	(0,474)
GDR		1,215	1,204	1,201	1,256	1,397	1,401	1,392	1,451
		(2,508)**	(2,445)**	(2,463)**	(2,573)**	(2,772)***	(2,732)***	(2,747)***	(2,900)***
IS		0,719	0,752	0,621	0,703	0,192	0,182	0,318	0,228
		(0,920)	(0,928)	(0,774)	(0,897)	(0,243)	(0,224)	(0,388)	(0,292)
R-squared		0,279	0,280	0,284	0,288	0,160	0,160	0,165	0,190
Adjusted R-Squared		0,180	0,166	0,171	0,175	0,076	0,060	0,066	0,094
Number of Observations		67	67	67	67	67	67	67	67
Country Dummies		YES	YES	YES	YES	NO	NO	NO	NO
Residuals									
Kolmogorov Smirnov Z		0,914	0,927	0,869	0,614	0,685	0,712	0,743	0,668
Asymp Sig (2-tailed)		0,374	0,357	0,436	0,845	0,735	0,691	0,638	0,764
Collinearity									
Tolerance max		0,988	0,922	0,932	0,973	0,994	0,923	0,953	0,983
Tolerance min		0,530	0,523	0,495	0,530	0,655	0,598	0,594	0,607
VIF max		1,888	1,910	2,019	1,888	1,528	1,673	1,683	1,648
VIF min		1,013	1,085	1,072	1,028	1,006	1,083	1,049	1,018

6.2 Qualitative Analysis

The second objective of this study was to identify key governance problems in the Baltic markets. The survey, through which the quantitative data was collected, also included qualitative open-ended questions regarding the general state of corporate governance, the level of minority protection and transparency and disclosure. In the following parts I summarize and analyze the answers as well as provide some real life case examples of the problems. Because of the nature of an open-ended questionnaire there are overlaps in the answers. This means that e.g. the transparency issue is discussed in both the general part and the transparency and disclosure part.

6.2.1 Corporate Governance in General

The participants were asked what they see as the biggest problem in the governance practices in the Baltic States. The most common answers are presented in Table 20.

The answers bring up two major problems. First and foremost the disclosure practices of local companies receive a notable amount of criticism. One broker commented that there are established rules for information disclosure but only a few companies follow them strictly. Another broker pointed out that especially continuous disclosure including periodical reporting and publishing of significant events such as profit warnings (in due time) seems to be a problem. Several other participants speculated that owner/managers are not motivated to disclose the information and might even be afraid of what full disclosure might mean for the companies and themselves.

Table 20: General Governance questions

The table presents the qualitative questions presented to the participants. The answers, which were mentioned by at least two participants, are reported along with the total number of participants who answered them in brackets. One participant's answer can score multiple hits in the answers table. For example for the first question the answer: "Lack of transparency and in many cases unequal treatment of shareholders" scores one point for "Equal treatment of shareholders" and one point for "Lack of transparency" category. Empty answers and "no comment" answers are not recorded. Points are scored on the basis of essence not the form (e.g. not by keywords).

Question	*Answers*		
General questions			
What is the biggest problem with corporate governance in the Baltic States?	Lack of transparency *(6)*	Corrupt/incompetent owners/managers *(4)*	Equal treatment of Shareholders *(2)*
What should be done to tackle the problem?	Better enforcement *(6)*	Regulator/ Stock exchange activity *(6)*	More laws, regulation, guidelines *(2)*
Are there country specific differences?	Latvia is the worst *(7)*	Estonia is the best *(4)*	- -
What is the cause of the differences?	Enforcement *(6)*	- -	- -

The second major topic focuses on company owners/managers and other company insiders. One participant stated: "There is little understanding in all but the larger firms as to what a capital markets strategy can bring to top management and Shareholders". Some other answers were even more critical stating corrupt owners/managers and their insider trading and transfer pricing as major problems. Due to the concentrated ownership, the excessive influence of the controlling shareholders and the subsequent lack of independent board members also raised concern in relation to equal treatment of shareholders.

The participants were asked solutions for the problems. According to the participants, better transparency and disclosure requires better enforcement of current laws, regulations and stock exchange rules. Most answers had in common the desire to see more activism from the stock exchange, local securities commission and other financial supervision authorities. Several

participants also suggested a combination of legal and financial sanctions to improve enforcement. Regarding poor management the participants' view was that the process will take time and require minority shareholder activism unless some outside marketforce causes change more rapidly.

When asked about country specific differences the answer was surprisingly clear. While Estonia stood up as the best of the countries, Latvia was clearly the worst of the crop. Latvia received special marks on especially its poor governance regarding disclosure of material events. Lithuania is considered to lie between the two, but still a long way from the Estonian levels. The participants saw poor enforcement as the main cause of these differences. As one answer pointed out, the legal and regulatory frameworks have already been modified to comply with EU directives: on paper the differences are non-existent. The lack of enforcement has already in some cases become somewhat of a business practice as the answer of one participant suggests: "...the *Latvian way* of making deals. All looks good on paper but practice is very different." The geographical location can also partly explain the situation: Estonia has benefited from the proximity of Finland and Sweden, countries that have strong influence on Estonian business practices. Latvia, on the other hand, has somewhat suffered from the strong Russian influence and dual role of several businessmen turned into politicians and vice versa. Some cause was also given to the privatization process in Latvia and Lithuania. As previously mentioned Lithuania forced privatized companies to get listed in the stock exchange.

The answers to the general part of the questionnaire reflect the problems of most transitional economies. On paper laws and regulations should guarantee Western style disclosure and investor protection, but practice is different due to lack of enforcement. The enforcement issue is slowly improving as more resources are allocated to the matter, but as always, the first step is to ensure legal enforcement followed by regulatory level matters. Estonia has already succeeded in making improvement in

regulatory enforcement, while Latvia and Lithuania are lagging behind. One way to "help" the local authorities in regulatory enforcement could come from the stock exchange, which could enforce the companies to improve transparency and minority protection through the contractual (listing) relation that connects the counter parties. However, as was pointed out by one of the participants, some Latvian and Lithuania companies actually never actively wanted a listing, so their compliance with stricter stock exchange rules is questionable. If the companies are forced out of the stock exchange, the minorities might loose their last real chance to protect their rights. This was also the view of Mr. Tiivas (see chapter 3.3).

The second common topic in transitional economies is the concentrated ownership, which might be beneficial in some cases when e.g. the company needs to be restructured, but can also turn to a real disadvantage if the position of an incompetent or corrupt management/owner cannot be challenged by e.g. a proxy fight. In these cases only governmental or regulatory intervention can change matters.

As one participant mentioned the current situation is partly due to the historical choices in the Baltic States, where a German –like governance mode was adapted. In this model the banks, which act as the major financers of the companies, effectively set the corporate governance standards by requiring disclosure and monitoring the companies as a condition for financing. This has resulted in a practice, which does not take care of public investors' interest, as their role as financers of the companies is secondary. However the question remains if another governance system would even have been possible, with the non-existent financial markets in the Baltics during the early 90's.

6.2.2 Minority Shareholder Protection and Ownership

The second set of questions contemplates on ownership structure and minority shareholder protection. The most common answers are presented in Table 21.

Table 21

Minority Protection and Ownership questions

The table presents the qualitative questions presented to the participants. The answers, which were mentioned by at least two participants, are mentioned with the total number of participants who mentioned them in brackets. One participant's answer can score multiple hits in the answers table. For example for the third question the answer: "Courts are incompetent and too costly" scores one point for "Courts are incompetent" and one point for "Not feasible due to costs" category. Empty answers and "no comment" answers are not recorded. Points are scored on the basis of essence not the form (e.g. not by keywords).

Question	*Answers*			
Minority protection and ownership				
Are minority rights adequately protected in the Baltic States?	In principle yes, practise not so clear (5)	In delisting no (Estonia, Lithuania) (3)	Negative (3)	Positive (2)
Are there country specific differences	No (similar situation in all countries) (4)	Estonia is the best one (4)	- -	- -
Can a minority shareholder protect his/her rights with legal means?	Courts are incompetent (5)	Not feasible due to costs/length of process (3)	A possibility for institutions (3)	Problem/impossible for small investors (3)
Are mandatory bid rules followed in an adequate manner	Problems with fair value (4)	Positive (3)	Country differences (2)	No (2)
What is your opinion of state ownership?	Negative (7)	Depends on the company (3)	Neutral (3)	Positive (2)
If it is bad, what is the major problem?	Less efficiency (3)	Less management control/corruption (3)	Less transparency / attitude towards minorities (2)	- -
Is concentrated ownership a good or a bad for CG?	Positive (6)	Negative (4)	Depends on the company (4)	- -

The first question is rather straightforward: Are minority shareholders rights adequately protected in the Baltics? The answers of the participants are somewhat divided, but the majority thinks that again on paper everything looks good, but the practice in certain cases is very different. Especially mandatory tender offers, squeeze outs and related legal proceedings are recognized as a problem field. In Lithuania the theoretical procedures for a squeeze out seem to be clear, but because the country got its first squeeze

out procedures only recently with the EU accession, they have not yet been tested in practice.

When asked about country specific differences in minority shareholder protection, most participants mentioned none. However, as was pointed out by two participants, there is currently one minor difference, which actually gives Latvia, at least in theory, better minority protection. In Latvia a minority buyout is mandatory before a delisting of a company share, while in Estonia and Lithuania it is not compulsory. [Estonian Securities Market Act (2001), Law on the Financial Instruments Market of Latvia (2004), Law on securities market of the Republic of Lithuania (2005)] This is problematic because e.g. in Lithuania there is a 95% mark for squeeze outs and sell outs, which means that a company with a majority owner of less than 95% can delist it's shares, without giving the minority shareholders a possibility to sell their shares. Even if there is a voluntary buyout before the delisting the price the majority offers might not be "fair". The problem of "fair" price is also evident in Latvia, despite the mandatory bid rule.

On the 16th of March 2005, Lisco Baltic Service (LBS) announced that it intends to delist its shares form the Vilnius Stock Exchange in December 2005. The company's majority owner (93%) is the Danish shipping group DFDS. On April 27th 2005 the General Shareholders' Meeting gave LBS the right to purchase its own shares from shareholders wishing to sell the shares under the terms and conditions provided by the legislation of Republic of Lithuania. So far (17.11.2005) the company has not made the decision about submitting the voluntary tender offer to buy own shares so that the right provided by the GSM could be implemented. According to the decision of the GSM the minimum price the company will pay is 20% lower than the weighted average market price of the company shares during the calendar month preceding the calendar week in which the share purchase transaction is entered into. The maximum price is 20% above the market

price of the same period. It remains to be seen if an offer is on its way as the company can delist its shares without a tender offer. (OMX 2005d)

The issue of "fair" price in mandatory tenders and squeeze outs was also taken up by several participants, when they were asked about the mandatory bid rules and proceedings. The question itself divided the participants fifty-fifty: One half was satisfied with current mandatory bid proceedings, while the other half was much more critical. There are also country specific differences on the issue, because in Lithuania, for example, the process is closely followed by the local SEC. The notion of fair price is a major cause of concern in several answers. Especially the lack of appraisal rights – the right of shareholders to demand the payment of an independently determined fair price for their shares – in buyouts is seen as problematic. This concern is a result of the policy of some acquirers who have been, as one participant put it: "…constantly trying to find ways to reduce the buyout price… through illegal means." One way to do this is to artificially lower the shareprice, manipulate the market, for a certain period before the announcement. This is relatively easy to do as the liquidity of many of the shares traded in these markets is quite modest. Another participant answered in a similar fashion that while bids are made according to the rules, in some cases there have been rumors that the main shareholders were paid more. One participant also wrote that there are still ways to avoid mandatory bids through the loopholes in the regulation or by putting an inadequate price tag on the shares. This will usually result in a failed bid. This method works, as the investors have little chances to convince the courts that the last price paid might not represent a "fair" price for the whole company. There are several examples of this tactic from Estonia.

On the 23rd of December the Swedish-Finnish telecommunication company TeliaSonera increased its share of Eesti Telecom above the 50% threshold by buying 100 shares, thus TeliaSonera was required to make a mandatory public offer for the remaining shares. TeliaSonera offered EUR 7.02 in cash

for each share. This was the same per share price paid by TeliaSonera for the purchase of 100 shares (total worth EUR 720). The offer price offered shareholders 0% premium over the market price, 13,2% lower than the year high and some 2% lower than the weighted average market price during the year. The mandatory bid offer failed. (OMX 2004a)

Another example is the recent Viisnurk case. On the 2nd of June the major holder of Viisnurk shares Baltic Republics Funds sold its 59,47% share of the company to Trigon Wood . With this ownership change the new owner was obligated to make a tender offer for the minority shareholders. The price the new shareholder paid was EUR 1,7337 per share (EEK 27,126), which was 24,6% lower than the last closing price on the market before the announcement (EUR 2,30). Trigon Wood offered the same price (EUR 1,7337) to the minorities. What makes this issue an interesting one is that according to their own website Trigon Asset Management was the initiator and advisor also to the Baltic Republics Fund (the Seller) together with Societe Generale Asset Management. The chairman of Trigon Asset Management was also the chairman of the Board of Viisnurk before and after the deal. As a result of the takeover bid the holdings of Trigon Wood increased by 6440 shares (EUR 11.165,03). (Trigon Asset Management, OMX 2005f, OMX 2005g)

Another legal problem, which especially harms the minority shareholders, can be found in the Lithuanian commercial law. Surprisingly, this was not taken up by any of the survey participants in their written questionnaire answers, but it came up in several discussions with the survey participants. The Lithuanian commercial law states that in corporate events, the record date, the date on which the company looks at its records to see who are the shareholders of the company, is actually the declaration date or the date of

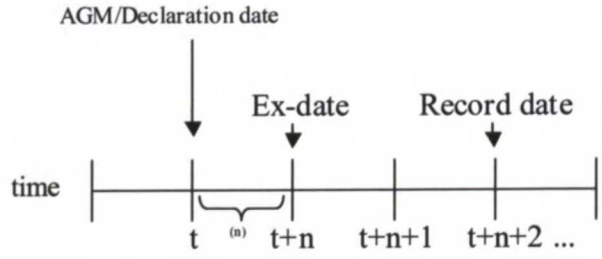
the general meeting.[15] Contrary to the norm of having a declaration date followed by an ex-date after some specific time interval (n) followed then by a record date two days later, in Lithuania the ex-date is before the declaration date. In plain English this means that the dividend, capital increase/decrease, etc. is ex before it is official or even announced! Figure 3 on the following page describes the procedure.

Figure 3

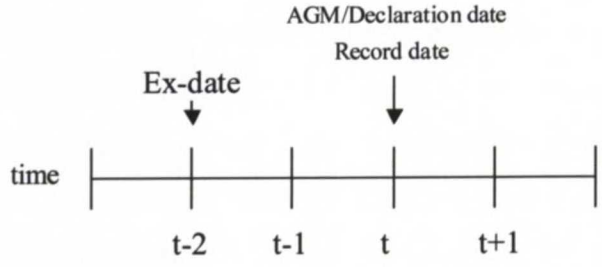
Corporate event procedure in Lithuania

The figure describes the Lithuanian procedure for corporate events such as dividend payouts, that differs from the normal procedure in place in most countries. In the Lithuanian system the declaration date is also the record date, which means that the ex-date is prior to the declaration date. (n) refers to a unspecified time period between the declaration and the ex-date.

Normal procedure



Lithuanian procedure



[15] Law on Companies of the Republic of Lithuania (2000), No. VIII-1835, Chapter 6, Article 62, point 7: "Persons, who were members of the company on the day when the General Meeting declared the dividends, shall be entitled to the dividend."

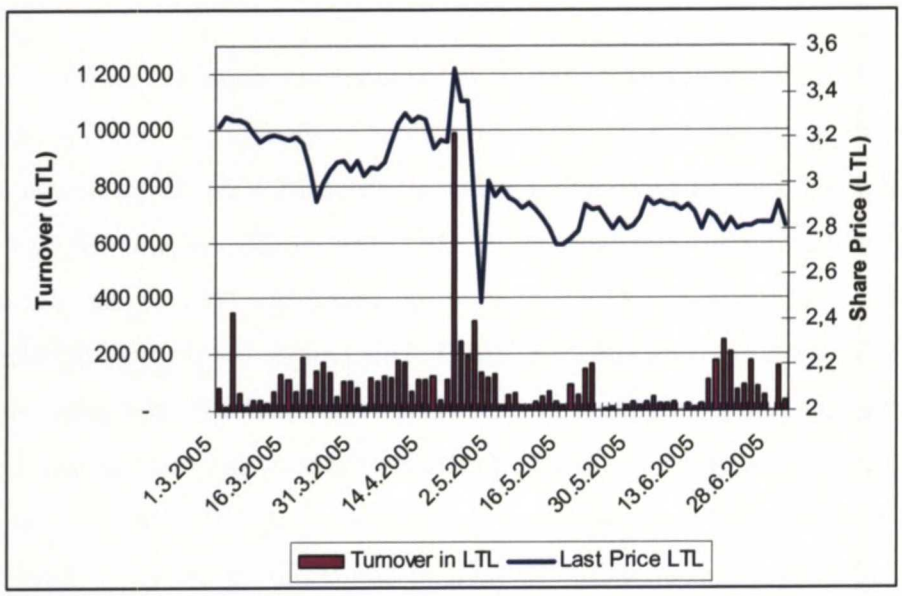
An example on the consequences of this law is the capital increase procedure of the Lithuanian power grid operator Ruty Skirstomieji Tinklai (RST) (see Figure 4 on the following page).

Ruty Skirstomieji Tinklai (RST) announced a plan to increase its sharecapital through a bonus issue, which would later be used to cover losses from 2004. The company's initial proposition to the shareholders general meeting was an increase of the share capital by roughly 70,4%, which corresponds to a 41,3% drop in the shareprice. The Ex-date for the capital increase was on April 26th 2005. This caused the price of the share to drop the daily maximum[16] of –14,3%. On April 27th the price also dropped the maximum of -14,2%. Because of lack of information, as there was no official announcement on the proposed capital increase, almost EUR 130,000 worth of shares exchanged hands during these two days. In the general meeting on April 28th 2005 it was decided, however, that the increase was to be only 16,7%, which meant that the market had seriously undervalued to shares (the drop should have been only -14,3%). Due to the general meeting the trading was suspended for the 28th, but on April 29th the shareprice increased +21,9% from the previous closing price. All this volatility was basically due to lack of information and due to the Lithuania law in place. (OMX 2005e)

[16] In Lithuania the daily price fluctuation can be +/- 15% from the morning opening price (auction price). There was some trading done on 26.4 and 27.4, which resulted in a last price and thus a price drop.

Figure 4

Ruty Skirstomieji Tinklai (RST) shareprice and turnover



When asked about legal means available for minority investors in protecting their rights the participants' view was clear: For institutions, foreign or local, litigation is a possibility, but for small retail investors the costs and especially the long processing time, on average up to several years, would be problematic, although theoretically possible. One participant's view was that litigation is worthwhile if the stake in question is over EUR 100.000. The second comment of many answers was that local courts are not educated enough to handle commercial cases and local regulatory bodies cannot help in these matter due to their own weakness and lack of resources. Litigation is also problematic due to lack of precedents, which makes it harder to estimate the possible outcomes of the proceedings pre-trial. The courts lack of understanding of financial law was also given as a reason why the courts often view "fair value" very differently compared to courts in the more developed markets. As one participant put it: "…fair value has not been adopted in economic but in legal terms."

The last two questions focused on the participants' views on the effects of a concentrated ownership structure and state ownership to the companies' corporate governance. The majority of the participants thought that state ownership is either negative or neutral at best. The main identified problems are poor efficiency and poor management control, which creates opportunities for corruption and stealing. One participant also mentioned similar problems with International Financial Institutions (IFI) ownership. Additionally non-stable governments and political interference created some concern. The effects of concentrated ownership on corporate governance in general produced a mixed response. One third said it has a positive impact, one third a negative impact and one third thought it depends on the company and the persons behind it. One participant said that while he thought that concentrated ownership was a good thing, he wished for more independent directors to be present, willing and able to monitor the actions of management.

6.2.3 Transparency and Disclosure

"They all range from bad to worse"

-One answer regarding country differences in Transparency & Disclosure

The last set of questions focused on transparency and disclosure practices of Baltic companies. The most common answers are presented in **Table 22.**

Table 22

Transparency and Disclosure questions

The table presents the qualitative questions presented to the participants. The answers, which were mentioned by at least two participants, are mentioned with the total number of participants who mentioned them in brackets. One participant's answer can score multiple hits in the answers table. For example for the third question the answer: "better enforcement of laws and more action from the stock exchange" scores one point for "Better enforcement" and one point for "Action from the Stock exchange and local regulators" category. Empty answers and "no comment" answers are not recorded. Points are scored on the basis of essence not the form (e.g. not by keywords).

Question	*Answers*			
Transparency and Disclosure				
Are Baltic companies generally transparent?	Positive (5)	Negative (5)	Depends on the company (5)	- -
Are there country specific differences?	Estonia is the best one (6)	Latvia is the worst one (3)	Latvia and Lithuania equal (2)	Lithuania improving (2)
What could be done to improve transparency?	Better enforcement (8)	Action from the Stock exchange and local regulators (3)	More laws (2)	- -

The answers are again mixed and partly overlapping with the answers in the general questions part before. According to many participants the transparency of the main listed and most liquid companies was good or adequate, while the small companies were lagging behind. In addition to the problems discussed before in the general questions part, a new problem emerged: lack of English disclosure and the poor disclosure of quarterly figures especially for the smaller companies. The answers for the general

part of the questionnaire also provide clues on other problem areas: publishing of significant events such as profit warnings. One concrete example of questionable disclosure practices of small caps in my opinion is that of Dvarcioniu Keramika from spring 2005.

On the 28th of February 2005 Dvarcioniu Keramika supplied the Vilnius Stock Exchange a notification of preliminary result of operation for the fiscal year 2004. The preliminary results show a loss of LTL 822 475 for the period. On the 8th of April the company issued the stock exchange a notification on the audited operating results for the year 2004, which show a loss of LTL 17 475 203 (42% of turnover). An increase in losses of roughly 20-times from the preliminary information 5 weeks earlier. (OMX2005b, OMX 2005c)

Regarding country specific differences in transparency and disclosure practices, the majority of participants viewed Estonia as the most advanced, followed by Latvia and Lithuania. Some participants again positioned Latvia as the worst country. As one participant pointed out, Latvia used to have problems with related party transactions and there are still a lot of beneficial owners, who hide behind offshore accounts. The largest and most liquid Lithuanian companies are viewed as having relatively good standards, but the Lithuanian market as a whole is still not very advanced. One participant was critical about the level of transparency and disclosure as a whole in all the Baltic countries. To improve the current situation, as discussed above in the general part, the participants suggested mainly better enforcement and more action from local regulators and the stock exchange.

7. Summary and Conclusions

This study focused on a less researched area of corporate governance by studying the small emerging stock markets of Estonia, Latvia and Lithuania. The study had two main objectives. The first was to test firm level effects of existing theories between good corporate governance and company valuations and performance, the effects of concentrated ownership to the firm valuation and performance and other effects linked to transparency and disclosure. The second objective was to identify key corporate governance problems in the Baltic markets today.

The study is based on a survey among local market participants that was conducted with a questionnaire in September 2005. The survey size was small, only 13 participants, but they represent a wide range of local market knowledge including several fund managers, brokers and analysts from major market players. The survey responses were used to create a unique firm level governance index, which was used to test the governance hypothesis. With the selected approach I was able to get a governance rating to 67 listed companies in the Baltic markets.

The effects of good corporate governance were tested using Ordinary Least Squares regression and Logistic regression. The findings on the positive relationship between good governance and higher market valuations are supportive of previous studies such as Klapper and Love (2004), Black (2001a, 2001b), Black, Jang and Kim (2005) and Durnev and Kim (2005). Contrary to previous studies [see e.g. Claessens and Djankov (1999a, 1999b), Claessens, Djankov and Pohl (1999) and Xu and Wang (1999)] I found no significant effects of concentrated ownership to firm valuation and performance. However, the evidence suggests that very high majority ownership stakes affect valuations negatively, implying possible expropriation. Contrary to results from Klapper and Love (2004), but inline with the results from Black, Jang and Kim (2005) we find no evidence that

better corporate governance would positively affect company performance. Regression results on governance effects to dividend policy and effects of good transparency to stock volatility were also very weak.

The survey participants also expressed their views on the key corporate governance problems they see in the Baltic markets. As with many other emerging markets, the lack of transparency and disclosure, especially continuous disclosure, including events such as profit warning, was identified as a major problem. Other problem areas included insider dealings and poor management quality. There are also large differences among the Baltic countries: Estonia is by far the most advanced while Latvia is seen to be the worst.

On a more concrete level, the survey found problems in the Lithuanian commercial law, which causes an unorthodox procedure for corporate events such as dividend payments, whereby the ex-date of the event is before the event is even official. Other legal issues related to minority protection include the lack of mandatory buyout laws in delistings in Estonia and Lithuania. The Estonian legal system also still has several loopholes and exception, which lower the effectiveness of existing mandatory bid regulation. Other problematic issues include poor possibilities for minorities to seek protection through legal means. In addition many courts are seen to have only limited understanding of commercial issues and there is a clear lack of precedents. This lack of understanding causes problems in complex legal cases including the determination of "fair" price in buyouts.

The main contributions of this study are the firm level evidence of the effects of good corporate governance in transitional economies. The results of this study show that good governance is an important factor even in markets where the ownership structure is very concentrated and where traditional western governance mechanism might not be effective. This

finding is critical when we consider private sector development in converging economies. With good governance, in both private and public sector, the whole economy can develop much faster than would otherwise be possible. The prime example of this is the current difference between Estonia and Latvia. The second major contribution is the identification of several concrete problems hampering good governance in the Baltics that even the EU accession has not corrected.

In order to further increase the knowledge of firm level effects of good governance, future research should focus more in transitional economies in general, because these markets have been to some extent neglected in the past. In the Baltics States future research should try to increase the sample size to include also non-listed companies. This would decrease the possibilities of statistical errors in the analysis. I also believe that in several years, if the disclosure practices of the company's improve, it should be possible to conduct a more thorough and precise method of rating companies' corporate governance practices more objectively, thus avoiding e.g. possible survey participant bias.

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Appendix I: The Questionnaire

Baltic Company Corporate Governance Evaluation **CONFIDENTIAL**

Please return filled evaluation to:
Jaakko Salmelin / *
Fax Number: *
Contact tel.number: *; Mobile *

1. Background information

Please fill in following information. This survey is for academic use only and strictly confidential. Background information is used solely for classification purposes (Local vs. Foreign, Broker/Analyst vs. Investor) and to contact the person.

First Name: _____ Last Name: _____

E-mail: _____ Tel.no: _____

Main working area (Please circle): **Broker** **Analyst** **Investor/Fund Manager** **Other (Please specify)** _____

Company: _____ Country _____

This questionnaire contains general (open) questions and a company rating table. In the open questions please use the space below the questions.

In the rating table, please give your rating on the three categories for each company by Circling your answer. "1" equals poor and "5" equals excellent.

2 Corporate Governance Rating Estonia

In Your opinion how do the following Estonia companies perfom in the three dimensions (Quality of Management and Board; Investor Rights; Transparency and Disclosure) below? Please **circle** the appropriate number for each company in each gategory.
1 is "Poor"; 5 is "Excellent"

Quality of Management and Board:
- Is the Board of Directors independent (enough)?
- Is there at least one Board member representing minority shareholders?
- Is the Management qualified and experienced (enough)?
- Based on your information do you think the current management uses company resources for personal gain?

Investor rights
- Are the minority shareholders treated fairly?
- Are all investors equally informed about amendments to the governing documents of the company, the authorization of additional shares and extraordinary transactions?
- Do all shareholders have sufficient and timely information regarding the date, time, location and agenda of general meetings?
- Is the annual audit done by a respected independent auditor?
- Does the majority owner respect minorities rights?
- Have you experienced or heard of problems with investor rights during the last 3 years? (audit, rumours etc.)

Transparency and Disclosure
- Are annual statements available in a reasonable time?
- Do the annual statements include the following:
  1. Financial and operating results of the company
  2. Company objectives
  3. Major Share ownership and voting rights
  4. Members of the Board and their remuneration
  5. Material foreseeable risk factors
  6. Material issues regarding employees and other stakeholders
  7. Governance structure and policies
- Is there timely disclosure of other corporate events?
- Does the firm conducts investor relation activities?
- Does English disclosures exist?
- Have there been any violations of disclosure regulations during last 3 years?
- Have you had problems with the company's disclosure practises?

	I do NOT follow the company [mark with (X)]	Quality of Management and Board					Investor rights					Transparency and Disclosure				
Main list		*Poor*				*Excellent*	*Poor*				*Excellent*	*Poor*				*Excellent*
Baltika		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Eesti Telekom		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Tallinna Kaubamaja		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Harju Elekter		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Merko		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Norma		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
I-List																
Kalev		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Klementi		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Rakvere Lihakombinaat		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Saku Õlletehas		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Tallinna Farmaatsiatehas		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Viisnurk		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5

2 Corporate Governance Rating Latvia

In Your opinion how do the following Latvian companies perfom in the three dimensions (Quality of Management and Board; Investor Rights; Transparency and Disclosure) below? Please **circle** the appropriate number for each company in each gategory.

1 is "Poor"; 5 is "Excellent"

Quality of Management and Board:
- Is the Board of Directors independent (enough)?
- Is there at least one Board member representing minority shareholders?
- Is the Management qualified and experienced (enough)?
- Based on your information do you think the current management uses company resources for personal gain?

Investor rights
- Are the minority shareholders treated fairly?
- Are all investors equally informed about amendments to the governing documents of the company, the authorization of additional shares and extraordinary transactions?
- Do all shareholders have sufficient and timely information regarding the date, time, location and agenda of general meetings?
- Is the annual audit done by a respected independent auditor?
- Does the majority owner respect minorities rights?
- Have you experienced or heard of problems with investor rights during the last 3 years? (audit, rumours etc.)

Transparency and Disclosure
- Are annual statements available in a reasonable time?
- Do the annual statements include the following:
  1. Financial and operating results of the company
  2. Company objectives
  3. Major Share ownership and voting rights
  4. Members of the Board and their remuneration
  5. Material foreseeable risk factors
  6. Material issues regarding employees and other stakeholders
  7. Governance structure and policies
- Is there timely disclosure of other corporate events?
- Does the firm conducts investor relation activities?
- Does English disclosures exist?
- Have there been any violations of disclosure regulations during last 3 years?
- Have you had problems with the company's disclosure practises?

	I do NOT follow the company [mark with (X)]	Quality of Management and Board					Investor rights					Transparency and Disclosure				
Main list		*Poor*				*Excellent*	*Poor*				*Excellent*	*Poor*				*Excellent*
SAF Tehnika		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Ventspils nafta		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Latvijas kuģniecība		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Latvijas Gaze		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
I-List																
Latvijas balzams		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Ditton pievadķēžu rūpnīca		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Grindeks		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Liepājas metalurgs		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Olainfarm		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Rīgas kuģu būvētava (Riga Shipyard)		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Rīgas Transporta flote (Riga Transport Fleet)		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Valmieras Stikla Šķiedra (Valmiera Glass Fabrik)		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5

2 Corporate Governance Rating Lithuania

In Your opinion how do the following Lithuanian companies perfom in the three dimensions (Quality of Management and Board; Investor Rights; Transparency and Disclosure) below? Please **circle** the appropriate number for each company in each gategory.
1 is "Poor"; 5 is "Excellent"

Quality of Management and Board:
- Is the Board of Directors independent (enough)?
- Is there at least one Board member representing minority shareholders?
- Is the Management qualified and experienced (enough)?
- Based on your information do you think the current management uses company resources for personal gain?

Investor rights
- Are the minority shareholders treated fairly?
- Are all investors equally informed about amendments to the governing documents of the company, the authorization of additional shares and extraordinary transactions?
- Do all shareholders have sufficient and timely information regarding the date, time, location and agenda of general meetings?
- Is the annual audit done by a respected independent auditor?
- Does the majority owner respect minorities rights?
- Have you experienced or heard of problems with investor rights during the last 3 years? (audit, rumours etc.)

Transparency and Disclosure
- Are annual statements available in a reasonable time?
- Do the annual statements include the following:
  1. Financial and operating results of the company
  2. Company objectives
  3. Major Share ownership and voting rights
  4. Members of the Board and their remuneration
  5. Material foreseeable risk factors
  6. Material issues regarding employees and other stakeholders
  7. Governance structure and policies
- Is there timely disclosure of other corporate events?
- Does the firm conducts investor relation activities?
- Does English disclosures exist?
- Have there been any violations of disclosure regulations during last 3 years?
- Have you had problems with the company's disclosure practises?

	I do NOT follow the company [mark with (X)]	Quality of Management and Board					Investor rights					Transparency and Disclosure				
Main list		*Poor*				*Excellent*	*Poor*				*Excellent*	*Poor*				*Excellent*
Ekranas		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Lietuvos Telekomas		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Pieno Zvaigzdes		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Rokiskio Suris		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Snaige		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Utenos Trikotazas		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Vilniaus Vingis		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Vilniaus Baldai		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Current trading list																
Alita		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Alytaus Tekstile		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Anyksciu Vynas		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Apranga		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Bankas Nord/lb Lietuva		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Bankas Snoras		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Dvarcioniu Keramika		1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
(continues)																

(continued)

Category	Quality of Management and Board					Investor rights					Transparency and Disclosure				
	Poor				Excellent	Poor				Excellent	Poor				Excellent
Grigiskes	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Gubernija	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Invalda	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Kauno Energija	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Kauno Tiekimas	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Klaipedos Baldai	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Klaipedos Juru Kroviniu Kompanija	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Klaipedos Nafta	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Lietuvos Dujos	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Lietuvos Elektrine	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Lietuvos Energija	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Lietuvos Juru Laivininkyste	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Lifosa	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Limarko Laivininkystes Kompanija	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Linas	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Lisco Baltic Service	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Mazeikiu Elektrine	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Mazeikiu Nafta	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Panevezio Statybos Trestas	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Pramprojektas	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Rytu Skirstomieji Tinklai	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Sanitas	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Stumbras	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Vakaru Skirstomieji Tinklai	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Vilniaus Degtine	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Siauliu Bankas	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Ukio Bankas	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
Zemaitijos Pienas	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5

General questions

In your opinion what is the biggest problem currently with Corporate Governance practices in the Baltic States?

_____

_____

What could/should be done to tackle the problem?

_____

_____

Are there country specific differences?

_____

_____

If country differences exist, is this problem dependant on the legal and regulatory framework of that particular country or is it a problem of enforcement of the laws and regulations?

_____

_____

Minority protection and ownership

Are minority shareholders rights adequately protected in the Baltic States?

_____

_____

Are there country specific differences?

_____

_____

Can a minority owner protect his/her rights adequately with legal means?

Based on your experience, are mandatory bid rules followed in an adequate manner, which protects minorities?

What is your opinion on state ownership? Is it good or bad for corporate governance? If it is a problem, what is the major cause of the problem?

Is the concentrated ownership in the Baltics a good or a bad thing for corporate governance?

Transparency and Disclosure

In your opinion are Baltic companies generally transparent?

Are there country specific differences?

What could be done to improve transparency?

Appendix II: Company List

Table 23

List of Estonian companies included in the survey and a description of their main activities

ESTONIA	*Description of activities*
Baltika	Manufacture and retail sale of textile products
Eesti Telekom	Telecommunications
Harju Elekter	Manufacture of electronic supplies
Kalev	Production and sales of confectionery products
Klementi	Production and sale of women's apparel
Merko	Construction
Norma	Manufacture of seat belt and car accessories
Rakvere Lihakombinaat	Purveyance, processing and sale of meat
Saku Õlletehas	Production of alcoholic beverages and soft drinks
Tallinna Farmaatsiatehas	Production of medications
Tallinna Kaubamaja	Retail
Viisnurk	Wood processing

Table 24

List of Latvian companies included in the survey and a description of their main activities

LATVIA	*Description of activities*
Latvijas Gāze	Sale of natural gas
Latvijas Kuģniecība	Cargo shipping
SAF Tehnika	Manufacture and sale of telecommunications equipment
Ventspils nafta	The central company of a diversified concern (Oil & Petrol)
Latvijas balzams	Production of alcoholic beverages
Ditton pievadķēžu rūpnīca	Manufacturing of vehicle components
Grindeks	Pharmaceuticals
Liepājas metalurgs	Ferrous metallurgy
Olainfarm	Pharmaceuticals
Rīgas kuģu būvētava (Riga Shipyard)	Engineering, constructing and shipbuilding
Rīgas Transporta flote (Riga Transport Fleet)	Shipping
Valmieras Stikla Šķiedra (Valmiera Glass Fabrik)	Production of glass fibre

Table 25

List of Lithuanian companies included in the survey and a description of their main activities

LITHUANIA	*Description of activities*
Ekranas	Manufacture of electronic equipment
Lietuvos Telekomas	Telecommunications
Pieno Zvaigzdes	Manufacture of milk and dairy products
Rokiskio Suris	Processing of milk and other raw material, production of milk and other products
Snaige	Manufacturing of household refrigerators, freezers and their spare parts
Utenos Trikotazas	Production of knitwear
Vilniaus Vingis	Manufacture of radio, television and communication equipment and apparatus
Vilniaus Baldai	Manufacture of furniture
Alita	Manufacture of sparkling grape wine and other alcoholic drinks
Alytaus Tekstile	Manufacture of cotton and cotton-polyester fabrics
Anyksciu Vynas	Manufacture and bottling of wine
Apranga	Wholesale and retail trade
Bankas Nord/lb Lietuva	Banking activities
Bankas Snoras	Banking activities
Dvarcioniu Keramika	Manufacture of ceramic products
Grigiskes	Production of paper, cardboard, fibre board and their products
Gubernija	Manufacture of beer and soft drinks
Invalda	Investment activities
Kauno Energija	Manufacture and sale of electricity and thermal energy
Kauno Tiekimas	Wholesale and retail trade, customs and terminal services, rent of premises
Klaipedos Baldai	Manufacture of furniture
Klaipedos Juru Kroviniu Kompanija	Stevedoring at Klaipėda port and aquatory
Klaipedos Nafta	Export and import of oil products
Lietuvos Dujos	Import and sale of natural gas
Lietuvos Elektrine	Manufacture, supply and distribution of electricity and thermal energy
Lietuvos Energija	Manufacture and distribution of electricity
Lietuvos Juru Laivininkyste	Maritime transport
Lifosa	Manufacture of inorganic acid, nitric, phosphorous, and potassium fertilizers
Limarko Laivininkystes Kompanija	Shipping of cargo
Linas	Manufacture of linen fabrics
Lisco Baltic Service	Cargo and passengers transportation by ferries and ships
Mazeikiu Elektrine	Manufacture, supply and distribution of electricity and thermal energy
Mazeikiu Nafta	Processing of oil and crude oil
Panevezio Statybos Trestas	Construction and design
Pramprojektas	Architecture and engineering
Rytu Skirstomieji Tinklai	Manufacture, supply and distribution of electricity and thermal energy
Sanitas	Manufacture of pharmaceutical preparations
Stumbras	Production and sale of ethyl alcohol, vodka, liqueurs, beer, and other alcoholic beverages
Vakaru Skirstomieji Tinklai	Supply and distribution of electricity
Vilniaus Degtine	Production of alcoholic and soft drinks
Siauliu Bankas	Banking activities
Ukio Bankas	Banking activities
Zemaitijos Pienas	Manufacture of various dairy products